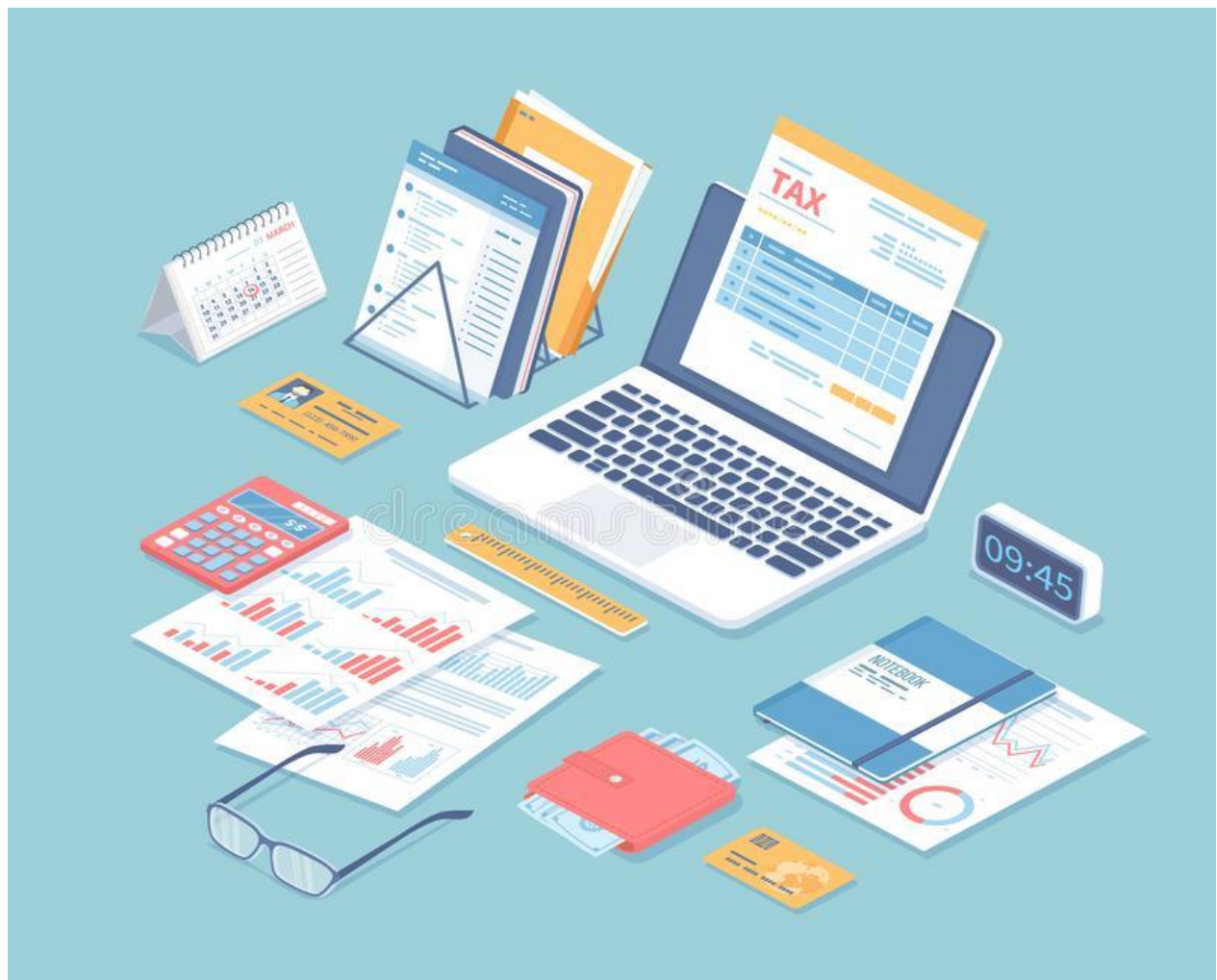




# ACCOUNTANCY

## PART-2

### Chapter 6: Cash Flow Statement



# Cash Flow Statement

## Introduction to Cash Flow Statement

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

- **Meaning of Cash Flow and Cash Flow Statement:**

**Cash Flow:** A cash flow is the inflow (receipt) and the outflow (payment) of Cash and Cash equivalents, where cash and cash equivalents include Cash, Bank Balance, Marketable Securities, etc. (unless specified otherwise, Current Investments are considered as Marketable Securities).

**Cash Flow Statement:** It is a statement that shows the inflows and the outflows of Cash and Cash Equivalents during the period. Inflows are those transactions that increase the Cash and Cash Equivalents and outflows are those transactions that decrease the Cash and Cash Equivalents. Such statement is prepared in accordance with the Accounting Standard-3 (Revised) on Cash Flow Statement. As per this accounting standard, cash flows are showed under the following 3 heads:

- Cash Flow from Operating Activities.
  - Cash Flow from Investing Activities.
  - Cash Flow from Financing Activities.
- **Cash Flow from Operating Activities:** Activities related to core or principal revenue generating activities of an enterprise.

**Cash Inflows:**

- i. from Cash Sales
- ii. from Debtors
- iii. as Commission and Royalty

**Cash Outflows:**

- i. Cash Purchases
- ii. Payment to creditors
- iii. Payment of wages

- **Cash Flow from Investing Activities:** Activities related to sale and purchase of long-term fixed assets and investments.

**Cash Inflows:**

- i. Proceeds from sale of Fixed Assets and Investments.
- ii. Interest and dividend received.

**Cash Outflows:**

- i. Purchase of long term fixed assets such as Land & Building, Plant & Machinery, Investments, etc.

- **Cash Flow from Financing Activities:** Activities related to capital or long term funds of an enterprise.

**Cash Inflows:**

- i. Proceeds from Issue of Shares and Debentures for Cash.
- ii. Proceeds from Long-term Borrowings such as Bonds, Loans, etc.

**Cash Outflows:**

- i. Repayment of Loans.
- ii. Redemption of Preference Shares and Debentures.
- iii. Buy-back of Equity Shares.
- iv. Payment of Dividend and Interest, etc.

- **Objectives of Cash Flow Statement:** A Cash Flow Statement is prepared:
  - i. to determine the sources of Cash and Cash Equivalents under operating, investing and financing activities of the enterprise.
  - ii. to determine the applications of Cash and Cash Equivalents for operating, investing and financing activities of the enterprise.
  - iii. to determine the net change in Cash and Cash Equivalents due to cash inflows and outflows for operating, investing and financing activities of the enterprise that take place between the 2 balance sheet dates.
- **Importance or Uses of Cash Flow Statement:** Preparation of Cash Flow Statement is helpful for following reasons:
  - i. **To facilitate Short-term Planning:** It helps in planning investments and assessing the financial requirements of the enterprise based on information provided in the statement about the sources and applications of Cash and Cash Equivalents.
  - ii. **To assess Liquidity and Solvency:** It helps in identifying the ability of the enterprise to meet its liabilities on time.
  - iii. **To manage Cash Efficiently:** It provides information about the cash position by reflecting either a surplus of cash or a deficit of cash in the statement. This helps the enterprise to take decisions about the investment of surplus cash and the arrangement of deficit funds.

- iv. **To facilitate Comparative Study:** It facilitates the comparison of actual cash flows with the budgeted cash flows to identify whether the inflows and outflows of cash are moving as per the plan. Such comparison will also reflect deviations of the actual cash flows from the budgeted cash flows for which necessary actions are then taken by the enterprise.
  - v. **To justify Cash Position:** Cash flow statement is prepared to record all the cash inflows and outflows which result in the surplus or deficit of cash for an enterprise. Since, all the cash transactions are presented in the statement, it becomes easy to identify the items which increase or decrease the cash balances.
  - vi. **To evaluate Management Decisions:** This statement classifies the cash transactions under 3 separate heads namely, operating, investing and financing. Such classification helps the users of the statement to evaluate whether the decisions taken by the management are appropriate from investing and financing point of view.
  - vii. **To take dividend decisions:** In order to declare or approve the dividends, every enterprise should comply with the prescribed provisions e.g., depositing the amount of dividend in a separate bank, etc. Accordingly, to identify whether the enterprise has sufficient funds for such compliance cash flow statement is referred by the management. Also, it helps in deciding how much dividend the enterprise should pay during a particular year.
- **Limitations of Cash Flow Statement:**
    - i. **Non-cash transactions are not shown:** It takes into consideration only cash inflows and cash outflows. Non-cash transactions are not considered for preparation of cash flow statement.
    - ii. **Not a substitute for an Income Statement:** Cash flow statement cannot be used as a substitute for an Income Statement because Income Statement is prepared on accrual basis of accounting whereas cash flow statement is prepared on cash basis. Also, it is not possible to compute net profit or loss from the cash flow statement.
    - iii. **Not a substitute for Balance Sheet:** Cash flow statement do not show the financial position of the enterprise and therefore, cannot be used as a substitute for Balance Sheet.
    - iv. **Historical in Nature:** Cash flow statement is prepared based on the cash inflows and outflows that have already taken place during the year and hence, it is historical in nature.
    - v. **Assessment of Liquidity:** Cash flow statement takes into consideration all the transactions of cash and cash equivalents. This cash and cash equivalents is just one of the components in the current assets which determine the liquidity position of the enterprise. Therefore, cash flow statement alone cannot help in determining the liquidity position of the enterprise.
    - vi. **Accuracy of Cash Flow Statement:** Since, the cash flow statement is prepared from the financial statements of an enterprise, accuracy of the same shall depend upon how accurately the financial statements of the enterprise are prepared.

## Terms used in Cash Flow Statement

### Definition of Key Terms used in Cash Flow Statement:

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

- **Disclosure in Cash Flow Statement:**

**Cash and Cash Equivalent is calculated as:**

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

### Classification of Cash Flows for Cash Flow Statement

- **Classification of Cash Flows as per Accounting Standard-3 (Revised):** This standard on Cash Flow Statement requires that all the inflows and outflows of the cash and cash equivalent during a particular period should be classified under 3 different heads as per the nature of transactions. These 3 heads are explained as follows:

- i. **Operating Activities:** These are the principal revenue generating activities of an entity. It includes all non-investing and non-financing activities. In a cash flow statement, net effect of all the inflows and outflows from operating activities is shown as Cash Flow from (or used in) Operating Activities.

Following is the list of operating activities for:

- **Financial Companies:** It includes all transactions related to:
  - a. purchase of securities.
  - b. sale of securities.
  - c. interest on loans granted.
  - d. interest on loans taken.



- e. dividends on securities.
- f. salaries, bonus and other employee benefits paid to employees.
- g. income tax paid and income tax refund received (unless such amounts are identified with investing or financing activities).
- **Non-Financial Companies:** It includes all transactions related to:
  - a. purchase of goods and/or availing of services.
  - b. sale of goods and/or rendering of services.
  - c. amounts received from trade receivables.
  - d. amounts paid to trade payables.
  - e. royalties, fees and commission, etc.
  - f. wages, salaries and other employee benefits paid to the workers and employees.
  - g. payment of claims and receipt of premium (in case of Insurance Companies)
  - h. income tax paid and income tax refund received (unless such amounts are identified with investing or financing activities).
- ii. **Investing Activities:** These include all activities related to the acquisition and disposal of Long-term Assets and other investments which are not classified as cash equivalents.  
Following is the list of investing activities:
  - a. purchase of fixed assets.
  - b. sale or disposal of fixed assets.
  - c. purchase of securities (in case of non-financial companies).
  - d. sale of securities (in case of non-financial companies).
  - e. loans and advances made to third parties (other than those made by a financial enterprise)
  - f. repayments received from loans and advances made to third parties (other than those made by a financial enterprise).
- iii. **Financing Activities:** These are those activities that change the size and composition of the owner's capital ( i.e., Equity and Preference Share Capital in case of a company) and borrowings of the enterprise.  
Following is the list of financing activities:
  - a. issue of shares or other similar instruments.
  - b. issue of debentures, loans, bonds, and other short-term borrowings.
  - c. changes in bank overdraft and cash credit.
  - d. buy-back of equity shares.

- e. repayment of borrowings including redemption of debentures.
- f. dividends on both equity and preference shares.
- g. Interest on debentures and loans (both short and long-term loans).

- **Transactions not regarded as Cash Flow:** These are the transactions that are mere movements in between the items of Cash and Cash Equivalents. This includes cash deposited in bank, cash withdrawn from the bank and purchase or sale of marketable securities.
- **Non-cash transactions:** These are the transactions in which the inflow or outflow of Cash or Cash Equivalent does not take place. Therefore, these non-cash transactions are not considered while preparing the Cash Flow Statements. These transactions include depreciation, amortisation, issue of bonus, etc.
- **Types of Businesses and Impact on Cash Flow:**

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

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

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

**Classification of Lending and Borrowing Functions**

| Function                            | Advancing Loans    |                    | Accepting Deposits from Public |                    |
|-------------------------------------|--------------------|--------------------|--------------------------------|--------------------|
|                                     | Interest Received  | Dividend Received  | Interest Paid                  | Dividend Paid      |
| <i>Business Activity</i>            |                    |                    |                                |                    |
| Trading or Non-Financial Enterprise | Investing Activity | Investing Activity | Financing Activity             | Financing Activity |
| Financial Enterprise                | Operating Activity | Operating Activity | Operating Activity             | Financing Activity |

Paid on capital raised from External sources ←

- **Importance of separate disclosure of cash flows under each activity:**
  - **Operating Activities:**
    - It acts an indicator of the extent to which the business operations successfully generate cash.
    - It determines operating efficiency of the entity.

- It helps in taking vital decisions with respect to use of cash for payment of dividends to shareholders, make new investments, expand projects, etc.
- It helps in forecasting and projecting future cash flows.

- **Investing Activities:**

- It represents the extent to which expenditure has been incurred to generate future revenue and cash flows.

- **Financing Activities:**

- It assists in assessing claims on future cash flows contributors of funds to the enterprise.

- **Format of Cash Flow Statement:**

Cash Flow Statement for the year ended XXX

| Particulars                                | Amount |
|--|--------|
| A. Cash Flow from Operating Activities     |        |
| • Cash received from customers             | XXX    |
| • Cash paid to employees and suppliers     | (XXX)  |
| • Cash generated from operating activities | XXX    |
| • Dividend Received                        | XXX    |
| • Interest Received                        | XXX    |
| • Interest Paid                            | (XXX)  |
| • Taxes Paid                               | (XXX)  |
| Net Cash Flow from Operating Activities    | XXXX   |
| B. Cash flow from Investing Activities     |        |
| • Purchase of Machinery                    | (XXX)  |
| • Proceeds from the sale of machinery      | XXX    |
| Net Cash Flow from Investing Activities    | (XXX)  |
| C. Cash flow from Financing Activities     |        |
| • Proceeds from capital contribution       | XXX    |
| • Proceeds from loan                       | XXX    |
| • Payment of loan                          | (XXX)  |
| Net Cash Flow from Financing Activities    | XXX    |
| Net Increase/Decrease in Cash (A+B+C)      | XXX    |
| Cash at beginning of the period            | XXX    |
| Cash at the end of the period              | XXX    |

- **Extraordinary Items:**

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



for damages received, etc.

## Cash Flow from Operating Activities

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

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

- **Steps to Ascertain Operating Profit Before Working Capital Changes**

**Steps to Prepare Cash Flow Statement (from Operating Activities)**  
**Ascertain Operating Profit before Working Capital Changes**

|              |  |
|--------------|--|
|              | Net Profit before Taxation & Extraordinary Items                   |
| <b>Add:</b>  | Depreciation   |
|              | Preliminary Expenses/Discount on issue of Debentures (written off) |
|              | Goodwill/Patents/Trademarks amortised                              |
|              | Interest on Borrowings and Debentures                              |
|              | Loss on sale of Fixed Assets                                       |
| <b>Less:</b> | Interest/Dividend/Rent received                                    |
|              | Profit on sale of Fixed Assets                                     |
|              | <b>Operating Profit before Working Capital Changes</b>             |

● **Ascertaining Cash Generated from Operations**

**Steps to Prepare Cash Flow Statement (from Operating Activities)**  
**Ascertain Cash generated from Operations**

|              |   |
|--------------|---|
|              | Operating Profit before Working Capital Changes |
| <b>Add:</b>  | ↓ in CA and ↑ in CL                             |
|              | Decrease in Stock/Trade Receivables, etc.       |
|              | Increase in Bills Payable/Creditors, etc.       |
| <b>Less:</b> | ↑ in CA and ↓ in CL                             |
|              | Increase in Stock/Trade Receivables, etc.       |
|              | Decrease in Bills Payable/Creditors, etc.       |
|              | <b>Cash generated from Operations</b>           |

## Cash Flow from Investing Activities

● **Cash Flow from Investing Activities:**

- These include all activities related to the acquisition and disposal of Long-term Assets and other investments which are not classified as cash equivalents.

- All cash inflows and outflows relating to the fixed assets, shares and related instruments of other enterprise including loans and advances to third parties and their repayments are classified under Investing Activities.
- It shows the extent to which investments have been made for resources that generate revenue and cash flows in future.
- It is determined by analyzing the changes in fixed assets, long-term investments in the beginning and at the end of the year for which specific accounts can be prepared using the values that are available.

#### Steps to Prepare Cash Flow Statement (*from Investing Activities*)

##### 1. Ascertain *Cash inflows* from Investing Activities

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

##### 2. Ascertain *Cash outflows* from Investing Activities

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

## Cash Flow from Financing Activities

### ● Cash Flow from Financing Activities:

- These are those activities that change the size and composition of the owner's capital (i.e., Equity and Preference Share Capital in case of a company) and borrowings of the enterprise.
- It is useful in estimating claims on cash flows by lenders of funds in future and therefore, are shown separately.
- It is computed by analyzing change in Equity and Preference Share Capital, Debentures and other borrowings. It also takes into consideration the amounts paid on account of interest (only in case of non-financing companies) and dividend (all types of companies).
- If shares or debentures are issued at a premium, Cash Flow Statement shows total cash received from the issue that includes both nominal value and the premium.
- Any amount of share issue expenses and underwriting commission is a cash outflow from financing activities.
- It does not take into consideration bonus issue as it is just a capitalization of reserves for which the company does not receive any cash for it. Similarly, conversion of debentures into

new debentures or shares involves no cash flow and therefore not considered in a cash flow statement.

### Steps to Prepare Cash Flow Statement (*from Financing Activities*)

#### Net Cash from (or used in) Financing Activities

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

#### Extraordinary Items

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

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## Treatment of Special Adjustments

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

### Accounting Treatment

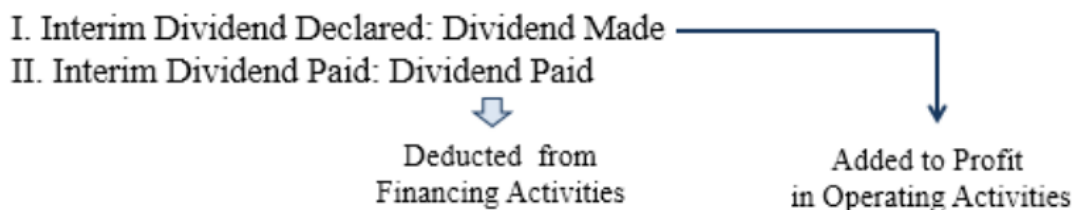
- (i) Increase in Bank O/D - Cash Inflows  
→ Added under Financing Activity
- (ii) Decrease in Bank O/D - Cash Outflows  
→ Deducted under Financing Activity

- **Proposed Dividend:**



| Accounting Treatment   |     |                                      |     |
|--|-----|--------------------------------------|-----|
| (i) Dividend Made (CY) → Added in Operating Activities       |     |                                      |     |
| (ii) Dividend Paid (PY) → Deducted from Financing Activities |     |                                      |     |
| Proposed Dividend Account                                    |     |                                      |     |
| Particulars  | Amt | Particulars                          | Amt |
| Bank A/c (Bal. Fig.-<br>Dividend Paid)                       |     | Balance b/d<br>(PY's Bal.)           |     |
| Balance c/d<br>(CY's Bal.)                                   |     | Profit & Loss A/c<br>(Dividend Made) |     |
|  |     |                                      |     |
|  |     |                                      |     |

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



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

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



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

● **Fixed Asset Account:**

i. If assets are shown at their Written Down Value i.e., after providing depreciation:

**Account Prepared : Fixed Assets A/c**

| Dr. Fixed Assets Account |     | Cr.                                |     |
|--------------------------|-----|------------------------------------|-----|
| Particular               | Amt | Particular                         | Amt |
| Bal. c/d                 | xxx | Dep. A/c (Charged during the year) | xxx |
| P&L A/c (Profit)         | xxx | P&L A/c (Loss)                     | xxx |
| Bank A/c (Purchase)      | xxx | Bank A/c (Sales)                   | xxx |
|                          |     | Bal. c/d                           | xxx |

**Accounting Treatment**

**a) Operating Activities**

**Add:** Depreciation charged during the year

**Subtract:** Profit on sale of Assets

**Add:** Loss on Sale of Assets

**b) Investing Activities**

**Subtract:** Purchase of fixed Assets

**Add:** Sale of fixed Assets

ii. If assets are shown at their Original Value:

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

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

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

**Accounting Treatment**

**a) Operating Activities**

**Add.** Depreciation charged during the year

**Subtract:** Profit on Sale of Asset

**Add.** Loss on Sale of Asset

**b) Investing Activities**

**Subtract:** Purchase of Fixed Assets

**Add.** Sale of Fixed Asset

## Preparation of Cash Flow Statement

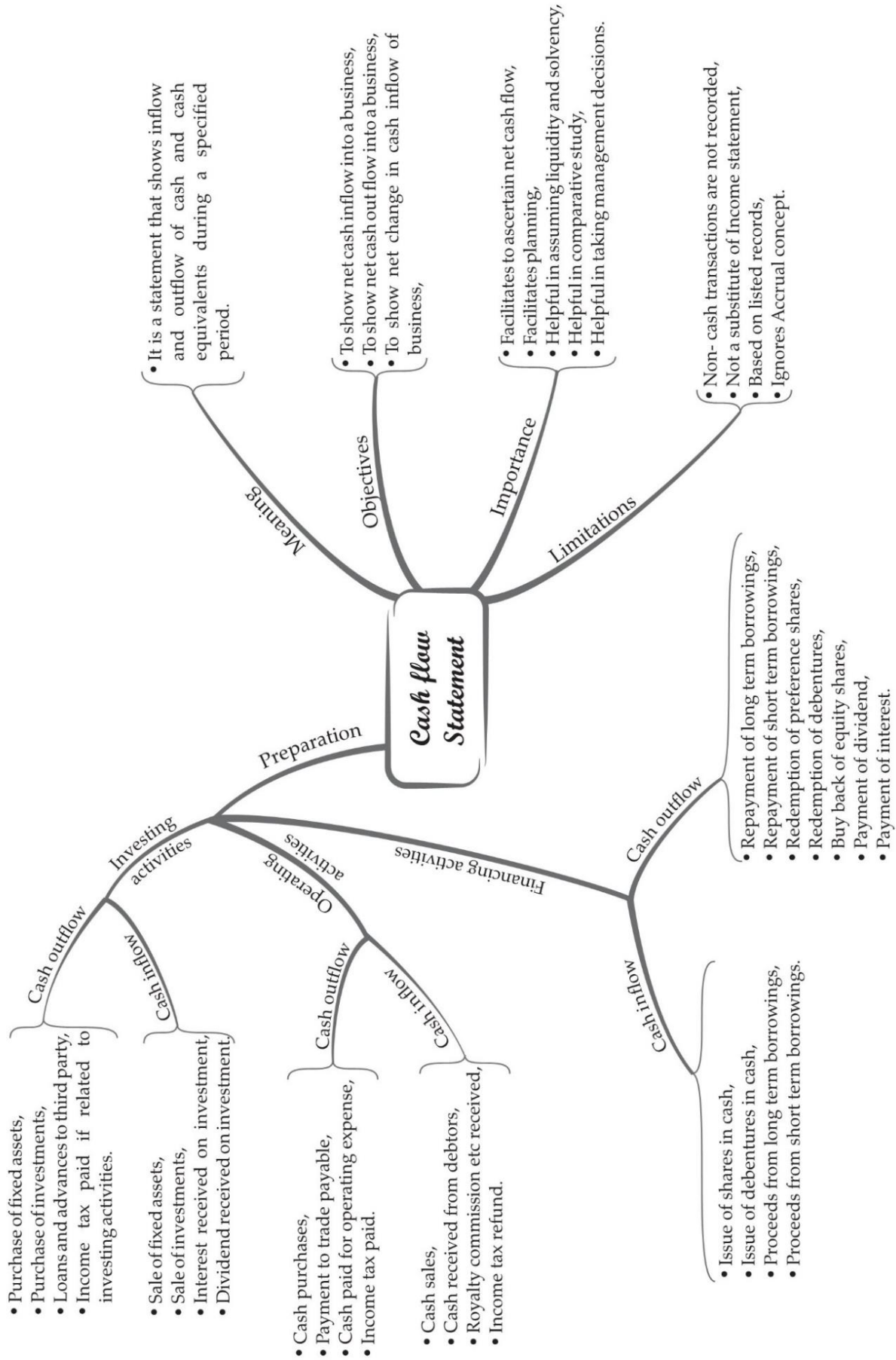
- **Steps for Preparing Cash Flow Statement:**

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

- **Precautions to be taken for preparing Cash Flow Statement:**

- **Balance in Statement of Profit and Loss:** Identify whether the balance in the Statement of Profit and Loss is positive or negative. When the opening balance is negative, it is to be added to the closing balance and when the opening balance is positive, it is to be deducted from the closing balance.
- **Balance of Other Reserves:** Identify whether the balances of other reserves have increased or decreased. When the increase is due to appropriation from Surplus, i.e., Balance in Statement of Profit and Loss, it is to be added to compute Net Profit before tax and Extraordinary Items.
- **Interest on borrowings:** Identify if the percentage of interest on borrowings is given and add the amount of interest paid to compute Net Profit before Working Capital Changes and show it as an 'Outflow' under Cash Flow from Financing Activities.
- **Interest on Investment:** Identify if the percentage of interest on Investment is given and deduct the amount of interest received to compute Net Profit before Working Capital Changes and show it as an 'Inflow' under cash Flow from Investing Activities.
- **Non-cash Expenses:** Identify if non-cash expenses are given and add them to compute Net Profit before Working Capital Changes.
- **Non-operating Expenses:** Identify if non-operating expenses are given and add them to compute Net Profit before Working Capital Changes. It will be shown as an outflow under appropriate head.
- **Non-operating Incomes:** Identify if non-operating incomes are given and deduct them to compute Net Profit before Working Capital Changes.

## CHAPTER 11 - CASH FLOW STATEMENT



## Important Questions

### Multiple Choice questions-

Question 1. Investments made with the purpose to resell after the expiry of three months will come under which of the following activity?

- (a) Investment
- (b) Financing
- (c) Operating
- (d) Cash equivalents

Question 2. Which of the following is the source of cash?

- (a) Cash deposited into bank
- (b) Cash withdrawn from the bank
- (c) Sale of marketable securities
- (d) Sale of goods for cash costing ₹ 20,000 for ₹ 16,000.

Question 3. While calculating cash flows from operating profit, which of the following is not considered in the net profit?

- (a) Amortisation of goodwill
- (b) Writing off bad debts
- (c) Writing off depreciation
- (d) Interest paid on bank overdraft

Question 4. Which of the following statement is incorrect about cash flow statement?

- (a) It provides information about cash inflows and cash outflows .
- (b) It provides information of flows of cash under three major categories
- (c) It reconciles bank balance with the bank balance as per bank statement
- (d) It helps in preparing cash budget

Question 5. Which of the following will come under operating activity?

- (a) Issue of shares for cash
- (b) Interest received on short-term investments
- (c) Trading commission received by a manufacturing company
- (d) Sale of marketable securities

Question 6. Which of the following will not come under anywhere in cash flow statement?

- (a) Repayment of borrowings
- (b) Issue of bonus shares
- (c) Sale of investments
- (d) Dividend paid

Question 7. A plant whose original cost was ₹ 40,000, accumulated depreciation provided till the date of sale was ₹ 15,000 was sold at 20% above the book value. Cash flow from operating activities will be

- (a) ₹ 48,000
- (b) ₹ 30,000
- (c) ₹ 18,000
- (d) ₹ 25,000

Question 8. Where will you show sale and purchase of shares and securities if it relates to revenue generating activity?

- (a) Cash flow from investment activities
- (b) Cash flows from financing activities
- (c) Cash flows from operating activities
- (d) Cash and cash equivalents

Question 9. Which of the following transaction is always shown under financing activities?

- (a) Interest received on investments
- (b) Interest paid on investments
- (c) Dividend paid
- (d) Dividend received

Question 10. Investments made by a financial enterprise with the purpose to resell after the expiry of three months will come under which of the following activity?

- (a) Investment
- (b) Financing
- (c) Operating
- (d) Cash equivalents

### Vezy Short Questions-

1. What is meant by 'Cash Flows'?
2. How will 'commission received' be treated while preparing cash-flow-statement?
3. How is 'dividend paid' treated by a financial enterprise for the purpose of preparing cash flow statement?
4. When can 'Receipt of Dividend' be classified as an operating activity State. Also give reason in support of your answer.
5. What is meant by 'Cash Flow Statement'?
6. What is meant by 'Cash Flows'?
7. How will 'commission received' be treated while preparing a cash-flow-statement?
8. State any one advantage of preparing cash flow statement.

### Short Questions-

1. What is a Cash Flow Statement?
2. How are the various activities classified (as per AS-3 revised) while preparing cash flow statement?
3. State the uses of cash flow statement?



4. What are the objectives of preparing cash flow statement?
5. State the meaning of the terms: Cash Equivalents, Cash flows.
6. "The nature/type of enterprise can change altogether the category into which a particular activity may be classified." Do you agree? Illustrate your answer.

### Long Questions-

1. Describe the procedure to prepare Cash Flow Statement.
2. Describe "Indirect" method of ascertaining Cash Flow from Operating Activities.
3. Explain the major Cash Inflow and outflows from investing activities.
4. Explain the major Cash Inflows and outflows from financing activities.

### MCQ Answers-

1. Answer: (d) Cash equivalents
2. Answer: (d) Sale of goods for cash costing ₹ 20,000 for ₹ 16,000.
3. Answer: (b) Writing off bad debts
4. Answer: (c) It reconciles bank balance with the bank balance as per bank statement
5. Answer: (c) Trading commission received by a manufacturing company
6. Answer: (b) Issue of bonus shares
7. Answer: (b) ₹ 30,000
8. Answer: (c) Cash flows from operating activities
9. Answer: (c) Dividend paid
10. Answer: (c) Operating

### Very Short Answers-

1. Answer: Cash Flows imply movement of cash in and out due to some non-cash items.
2. Answer: It will be treated as Cash flows from operating activities.
3. Answer: Dividend paid is treated as a financing activity.
4. Answer: Receipt of dividend can be an operating activity for a financial company as it is a principal revenue generating activity.
5. Answer: A Cash Flow Statement is a statement that provides information about the historical changes in Cash & Cash Equivalents of an enterprise by classifying cash flows into Operating, Investing and Financing Activities.
6. Answer: Cash Flows imply movement of cash in and out due to some non-cash items.

7. Answer: It will be treated as Cash flows from operating activities.

8. Answer: It helps in short term financial planning.

## Short Answers-

1. A financial statement that represents the inflow and outflow of cash and cash equivalents of a company is called a cash flow statement. It shows how well a company can manage its cash position and generates enough cash to pay the obligations in the form of debt and also run the operational expenses.
2. Three types of activities are defined:
  - a. Operating Activities.
  - b. Financing Activities.
  - c. Investing Activities.
3. Following are uses of cash flow statement:
  - i. Useful for evaluating cash position of a firm.
  - ii. Helpful in finding deficiencies and variations in firms performance which helps in effective decision making.
  - iii. It helps in assessment of liquidity of a company.
  - iv. It analyses cash receipts and payments from the various activities of a company and helps in short term planning.
  - v. It helps in segregating cash flows obtained from the various activities of the business.
  - vi. It helps in providing decision about distribution of profit.
  - vii. It is useful for short term financial analysis.
4. Following are the objectives:
  - i. To determine inflow and outflow of cash and the cash equivalents obtained from the different kind of activities.
  - ii. To seek out various reasons responsible for change in cash balances during the accounting period.
  - iii. It helps in depicting the position of the company in terms of liquidity and solvency.
  - iv. It also helps in determining the requirement and the corresponding availability of cash for business in future.

5. Cash equivalents are investments that are highly liquid in nature and do not change value easily. Cash equivalents are essential for managing short term cash requirements or any such investments. For example treasury bills.

Cash Flows: It is the inflow and outflow of cash and cash equivalents. Cash inflows boosts cash balance and cash outflow has a negative impact on cash balance.

6. Yes, it can happen. For example, there are two firms one is engaged in real estate and the other in general business. For the firm engaged in real estate sale of building will be regarded as part of operating activity while for the firm dealing with general business, purchase or sale of a building is regarded as an investing activity. Therefore, it can be said that nature and type of enterprise determines the type of activities.

### Long Answers-

1. Following steps are followed:

- i. Determine cash flows obtained from operating activities.
- ii. Determine cash flows obtained from financing activities.
- iii. Determine cash flow obtained from investing activities.
- iv. Determine net increase or decrease which is obtained by adding amounts from all the cash flow activities.
- v. Add the opening balance of cash and the cash equivalents and deduct the same from the amount determined in the previous step.

There are two methods which are used for preparation of cash flow statement:

1. Direct Method
2. Indirect Method.

## Direct Method

## Cash Flow Statement

|           | Particulars  | Amount<br>Rs | Amount<br>Rs |
|-----------|--|--------------|--------------|
| <b>A.</b> | <b>Cash Flow from Operating Activities</b>   |              |              |
|           | Cash Sales   | **           |              |
|           | Cash receipt from Debtors  | **           |              |
|           | <i>Less:</i> Cash Purchases  | **           |              |
|           | Cash paid to creditors and other expenses  | **           |              |
|           | Cash Generated from Operating Activities   | **           |              |
|           | <i>Less:</i> Income Tax Paid   | **           |              |
|           | Cash flow before Extraordinary Items   | **           |              |
|           | <i>Add/Less:</i> Extraordinary Items   | **           |              |
|           | <b>Net Cash Flow from (used in) Operating Activities</b>   | **           | **           |
| <b>B.</b> | <b>Cash Flow from Investing Activities</b>   | **           |              |
|           | Sale of Fixed Assets   | **           |              |
|           | Sale of long-term Investments  | **           |              |
|           | Interest Received  | **           |              |
|           | Dividend Received  | **           |              |
|           | Rent Received  | **           |              |
|           | <i>Less:</i> Purchase of Fixed Assets  | **           |              |
|           | <i>Less:</i> Purchase of long-term Investment  | **           |              |
|           | <b>Net Cash Flow from Investing Activities</b>   | **           | **           |
| <b>C.</b> | <b>Cash Flow from Financing Activities</b>   |              |              |
|           | Proceeds from Issue of Shares  | **           |              |
|           | Proceeds from Issue of Debentures and Other Long-term Borrowings   | **           |              |
|           | <i>Less:</i> Repayment of Debentures and Other Long-term Borrowings  | **           |              |
|           | <i>Less:</i> Redemption of Preference Shares   | **           |              |
|           | <i>Less:</i> Interest Paid   | **           |              |
|           | <i>Less:</i> Dividend Paid   | **           |              |
|           | Net Cash flow from Financing Activities  | **           | **           |
|           | Net Increase (or Decrease in Cash and Cash Equivalents (A+B+C))  |              | **           |
|           | Cash and Cash Equivalents at the beginning (Cash in Hand,<br>Cash at Bank, Marketable Securities, Short-term Deposits) |              | **           |
|           | <b>Cash and Cash Equivalent at the end</b>   |              | **           |

## Indirect Method

## Cash Flow Statement

|           | Particulars   | Amount<br>Rs | Amount<br>Rs |
|-----------|---|--------------|--------------|
| <b>A.</b> | <b>Cash Flow from Operating Activities:</b>   |              |              |
|           | Net Profit before tax and extraordinary items   |              | ***          |
|           | <i>Add:</i> Non-Cash Expenses and non operating expenses.   |              |              |
|           | Depreciation  | **           |              |
|           | Goodwill  | **           |              |
|           | Interest paid   | **           |              |
|           | Loss on sale of fixed assets  | **           | **           |
|           | <i>Less:</i> Non-Operating Incomes.   |              |              |
|           | Dividend received   | **           |              |
|           | Profit on sale of fixed assets  | **           |              |
|           | Interest received   | **           | **           |
|           | Operating Profit before Working Capital Changes   |              | ***          |
|           | <i>Add:</i> Decrease in Current Assets  | ***          |              |
|           | Increase in Current Liabilities   | **           | ***          |
|           | <i>Less:</i> Increase in Current Assets   | ***          |              |
|           | Decrease in Current Liabilities   | ***          | ***          |
|           | Cash generated from Operating Activities  |              | ***          |
|           | <i>Less:</i> Income tax paid  |              | ***          |
|           | Cash flow before Extra ordinary items   |              | ***          |
|           | <i>Add/Less:</i> Extra ordinary items   |              | ***          |
|           | <b>Net Cash Flow from Operating Activities</b>  |              | ***          |
| <b>B.</b> | <b>Cash Flow from Investing Activities</b>  | **           |              |
|           | Sale of Fixed Assets  | **           |              |
|           | Sale of Long-term Investments   | **           |              |
|           | Interest Received   | **           |              |
|           | Dividend Received   | **           |              |
|           | Rent Received   | **           |              |
|           | <i>Less:</i> Purchase of Fixed Assets   | **           |              |
|           | <i>Less:</i> Purchase of long term Investment   | **           |              |
|           | <b>Net Cash Flow from Investing Activities</b>  | **           | **           |
| <b>C.</b> | <b>Cash Flow from Financing Activities</b>  |              |              |
|           | Proceeds from Issue of shares   | **           |              |
|           | Proceeds from Issue of Debentures and other Long-term Borrowings  | **           |              |
|           | <i>Less:</i> Repayment of Debentures and other Long-term Borrowings   | **           |              |
|           | <i>Less:</i> Redemption of preference Share   | **           |              |
|           | <i>Less:</i> Interest paid  | **           |              |
|           | <i>Less:</i> Dividend paid  | **           |              |
|           | Net Cash Flow from Financing Activities   | **           | **           |
|           | Net Increase (or Decrease in Cash and Cash Equivalents (A+B+C))   |              | **           |
|           | Cash and Cash Equivalents at the beginning (Cash in Hand, Cash at Bank, Marketable Securities, Short-term Deposits) |              | **           |
|           | <b>Cash and Cash Equivalents at the end</b>   |              | **           |



Note: Preparation of Cash Flow Statement using Direct Method has been excluded from the prescribed syllabus. The format is given since the question has not specified the method explicitly. Students can refer to the direct method for the knowledge purpose.

2. In indirect method cash flow statement begins with net income or loss, and thereafter the additions or deductions from that amount for non-cash expense and revenue items, which results in cash flow from operating activities.

Following are some items:

- i. Items that are non-cash in nature like goodwill, depreciation are added towards net profit.
- ii. Expenses that are non-operating in nature like transfer to reserve and loss on sale of fixed assets which are added back to show Net Profit earned.
- iii. Provision such as discount for debtors, doubtful debts, proposed dividends etc. should be added to Net Profit.
- iv. Any decrease in current assets and an increase in current liabilities is added to operating profit.

Following items get deducted from net profit of P & L account:

- i. Incomes that are non-operating in nature like sale of fixed assets.
  - ii. Non-trading incomes like dividend received, tax refund, interest received.
  - iii. Increase in current assets and decrease in current liabilities.
3. Investing activities consist of sales and purchase of fixed assets that are long term in nature, like building, land, furniture and plant and machinery etc. It also includes sale and purchase of items that are not cash equivalents. If any income is received from these assets it is regarded as a part of investing activities.

The major cash inflows and outflows that are involved in investing activities are:

- i. Cash receipts that are obtained when fixed assets are sold off and it includes intangible assets.
- ii. Acquiring fixed assets which also includes intangibles like goodwill using cash payments, the payments is for the research and development and assets that are self-constructed.
- iii. Acquiring shares, debt instruments or warrants using cash payments.

- iv. Disposal of shares and warrants that yield cash receipts.
- v. Loans and cash advances that are made to third parties (does not includes loans and advances made by financial enterprises).
- vi. Cash receipts obtained from any insurance company for a property that is involved in accident.
- vii. Cash receipts that are obtained for repayment of loans and cash advances made to third parties.
- viii. Any type of income that is obtained from fixed assets like interest, dividend and rent (not in case of financial enterprises).

**Direct Method**

**Cash Flow Statement**

|           | Particulars  | Amount<br>Rs | Amount<br>Rs |
|-----------|--|--------------|--------------|
|           | <b>Net Cash Flow from (used in) Operating Activities</b> | **           | **           |
| <b>B.</b> | <b>Cash Flow from Investing Activities</b>               | **           |              |
|           | Sale of Fixed Assets                                     | **           |              |
|           | Sale of long-term Investments                            | **           |              |
|           | Interest Received  | **           |              |
|           | Dividend Received  | **           |              |
|           | Rent Received  | **           |              |
|           | <i>Less: Purchase of Fixed Assets</i>                    | **           |              |
|           | <i>Less: Purchase of long-term Investments</i>           | **           |              |
|           | <b>Net Cash Flow from Investing Activities</b>           | **           | **           |

## Indirect Method

## Cash Flow Statement

| Particulars                                    | Amount | Amount |
|--|--------|--------|
|  | Rs     | Rs     |
| <b>Net Cash Flow from Operating Activities</b> |        | ***    |
| <b>Cash Flow from Investing Activities</b>     | **     |        |
| Sale of Fixed Assets                           | **     |        |
| Sale of Long-term Investments                  | **     |        |
| Interest Received                              | **     |        |
| Dividend Received                              | **     |        |
| Rent Received                                  | **     |        |
| <i>Less: Purchase of Fixed Assets</i>          | **     |        |
| <i>Less: Purchase of long term Investment</i>  | **     |        |
| <b>Net Cash Flow from Investing Activities</b> | **     | **     |

Note: Preparation of Cash Flow Statement using Direct Method has been excluded from the prescribed syllabus. The format is given since the question has not specified the method explicitly. Students can refer to the direct method for the knowledge purpose.

4. Financing activities are those activities that are related to capital or long term funds of an enterprise. These activities results in the change in the capital and borrowed funds.

As per the AS3, the major cash inflows from financing activities are as follows:

- i. Cash proceeds from issue of shares and other similar instruments.
- ii. Cash proceeds from issue of debentures, loans, notes, bonds, and other short and long-term borrowings.

As per the AS3, the major cash outflows from financing activities are as follows:

- i. Cash repayments of the amount borrowed in form of debentures, loans, notes bonds, and

other short and long-term borrowings.

ii. Buy-back of shares and debentures.

iii. Interest paid on debentures, loans, and advances.

iv. Dividend paid to the preference shareholders and equity shareholders.

An important point that must be noted is that the purchase and sale of securities, interest paid or received and dividend received is treated as cash flow from operating activities for an investment company. But dividend paid is treated as cash flow from financing activities.

### Direct Method

#### Cash Flow Statement

|  | Particulars  | Amount | Amount |
|--|--|--------|--------|
|  |  | Rs     | Rs     |
|  | <b>Net Cash Flow from Investing Activities</b>   | **     | **     |
|  | <b>Cash Flow from Financing Activities</b>   |        |        |
|  | Proceeds from Issue of Shares  | **     |        |
|  | Proceeds from Issue of Debentures and Other Long-term Borrowings   | **     |        |
|  | <i>Less: Repayment of Debentures and Other Long-term Borrowings</i>  | **     |        |
|  | <i>Less: Redemption of Preference Shares</i>   | **     |        |
|  | <i>Less: Interest Paid</i>   | **     |        |
|  | <i>Less: Dividend Paid</i>   | **     |        |
|  | Net Cash flow from Financing Activities  | **     | **     |
|  | Net Increase (or Decrease in Cash and Cash Equivalents (A+B+C))  |        | **     |
|  | Cash and Cash Equivalents at the beginning (Cash in Hand,<br>Cash at Bank, Marketable Securities, Short-term Deposits) |        | **     |
|  | <b>Cash and Cash Equivalent at the end</b>   |        | **     |

**Indirect Method****Cash Flow Statement**

| Particulars  | Amount | Amount |
|--|--------|--------|
|  | Rs     | Rs     |
| <b>Net Cash Flow from Investing Activities</b>   | **     | **     |
| <b>Cash Flow from Financing Activities</b>   |        |        |
| Proceeds from Issue of shares  | **     |        |
| Proceeds from Issue of Debentures and other Long-term Borrowings   | **     |        |
| <i>Less: Repayment of Debentures and other Long-term Borrowings</i>  | **     |        |
| <i>Less: Redemption of preference Share</i>  | **     |        |
| <i>Less: Interest paid</i>   | **     |        |
| <i>Less: Dividend paid</i>   | **     |        |
| Net Cash Flow from Financing Activities  | **     | **     |
| Net Increase (or Decrease in Cash and Cash Equivalents (A+B+C))  |        | **     |
| Cash and Cash Equivalents at the beginning (Cash in Hand,<br>Cash at Bank, Marketable Securities, Short-term Deposits) |        | **     |
| <b>Cash and Cash Equivalents at the end</b>  |        | **     |

**Note:** Preparation of Cash Flow Statement using Direct Method has been excluded from the prescribed syllabus. The format is given since the question has not specified the method explicitly. Students can refer to the direct method for the knowledge purpose.