

CHAPTER-1

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1.1 PROBLEM SELECTION :

The users of the financial statements of an enterprise are taking interest in the sources and application of cash and cash equivalents. This is happened in case of the nature of the activities of an organization and it is not affected or influenced by whether they consider cash as the product of the organization. Organizations are needed cash for various reasons such as:

- To organize their operations smoothly
- To pay their liabilities
- To provide return to their investors.

Cash flow statements are provided with the other financial statements in the annual reports of the companies. The information provided in these statements helps the users

- To find out the changes in net assets of an organization
- To find out the changes in the financial structure of an organization
- To find out the liquidity and solvency position of an organization
- To know about the ability of an organization to make changes in time if the circumstances and opportunities are changing.

By studying cash flow statements, one can come to know about the capacity of the organizations to generate cash and cash equivalents. It helps the users in comparing the present value of the future cash flows of the different organizations. It removes the effects of using different accounting treatments for the repeated transactions and events. In this way, it improves the comparison of the various enterprises' reporting about operating performance. To know about the amount, timing and surety of future cash flows, historical information about cash flow is used. It is also helpful in checking the correctness of the past judgments of future cash flows. It also helps in determining the relationship between cash flow and profitability and the effect of inflation.

In this study, the matters relating to the cash flow statements, which normally forms a part of the financial statements of various enterprises to which the Accounting standard (AS) 3, 'Cash Flow Statements', become mandatory, is discussed in the light of, and on the basis of, the said Accounting Standard.

1.2 CONCEPTUAL FRAMEWORK OF CASH FLOW STATEMENT :

1.2.1 OBJECTIVE :

Information provided in cash flow statement of an enterprise helps the users of financial statements to examine the capability and various sources to generate cash and cash equivalents. It also helps in knowing how the organizations are using those cash flows. At the time of making investment, the investors are interested in sources of cash and cash equivalents, its timing and its certainty. The economic decisions of the users are taken on the basis of these factors. By means of a cash flow statement, the standard deals with the changes in cash and cash equivalents of an organization in the past. In cash flow statement, various activities are classified into operating, investing and financing activities.

1.2.2 SCOPE :

- (1) Cash flow statement should be prepared by an organization. It should also be presented for each period during which financial statements are prepared and presented.
- (2) Various stakeholders of an organization are interested in the sources of cash and cash equivalents of an organization. This is the case which is not affected or influenced by the type of organizations' activities. It is also not affected by whether they consider cash as the product of the organization. In spite of having different principles and activities, organizations need cash almost for the same purposes. They need cash for various reasons such as to run business smoothly, to pay their liabilities on time and to provide their investors a healthy return.

1.2.3 DEFINITIONS :

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

- **Cash** : Cash includes cash on hand and bank demand deposits.
- **Cash Equivalents** : Cash equivalents are such investments which are short-term and highly liquid. They can be easily converted into cash. They are subject to an important risk of changes in value. It includes Money-market holdings, Short-term government bonds, Treasury bills, Marketable securities, Commercial papers etc.

- **Cash Flows** : Cash flow means cash inflow and cash outflow of cash and cash equivalents.
- **Operating Activities** : Operating activities are the activities that directly affect the cash inflow and cash outflow of an organization. They determine net income of an organization on the basis of the activities of revenue-production principle of an organization.
- **Investing Activities** : Investing activities are the purchase and sell of long-term fixed assets and other investments which are not included in cash equivalents.
- **Financing Activities** : Financing activities are activities that result in changes in the size of the owners' funds. Financing activities may include buying and selling of products, issuing stocks and bonds, arranging loans and borrowings of an organization etc.

1.2.4 LEGAL PROVISIONS : AS – 3 :

- (1) From 1-4-2004, it is mandatory to present cash flow statement in the annual reports of the organizations which comes in any one or more of the following groups during any accounting period –
 - (a) Organizations whose equity or debt securities are listed either on Indian stock exchange or stock exchanges outside India.
 - (b) Organizations which are about to issue equity or debt securities as proved by the resolution of Board of Director in this respect.
 - (c) Banks which includes all the co-operative banks.
 - (d) Financial Institutions.
 - (e) Organizations which are doing the business of insurance.
 - (f) All the organizations whose turnover for the previous accounting period is more than Rs. 50 crore. It should be on the basis of the financial statements which are audited by the auditors. These organizations may be commercial, industrial or business reporting organizations. Other incomes are not included in turnover.
 - (g) All the organizations whose borrowings for the previous accounting period are more than Rs. 10 crore. Such borrowings include public deposits also. These organizations may be commercial, industrial or business reporting organizations.

- (h) All the holding and subsidiary organizations which falls under any one of the above categories during any accounting period.
- (2) The organizations which do not come under any one of the above categories are motivated to adopt this Accounting Standard even if it is voluntary for them.
- (3) The organization will not be liable for exemption from applying this Accounting Standard even if it comes under any one or more of the above categories and with that, covers the cases. But, the organization will be liable for exemption from applying this Accounting Standard if it covers the cases in any of the above categories for two continuous years.
- (4) If any organization does not fall under the above categories during the previous years but comes under the above categories in the current accounting period, then this Accounting Standard is mandatory from the current accounting period. In this case, the organization is not required to disclose the figures of corresponding previous years.
- (5) If any organization fall under any one of the above said categories and if it is mandatory to prepare and present a cash flow statement, then the organization should prepare and present it for all the years in which financial statements are prepared and presented. If any organization does not prepare and present cash flow statement, this fact should be disclosed in the financial statements.

1.2.5 BENEFITS OF CASH FLOW INFORMATION :

- Cash flow statements are provided with the other financial statements in the annual reports of the companies. The information provided in these statements helps the users
- To find out the changes in net assets of an organization
 - To find out the changes in the financial structure of an organization
 - To find out the liquidity and solvency position of an organization
 - To know about the ability of an organization to make changes in time if the circumstances and opportunities are changing.

By studying cash flow statements, one can come to know about the capacity of the organizations to generate cash and cash equivalents. It helps the users in comparing the present value of the future cash flows of the different organizations. It removes the effects of using different accounting treatments for the repeated transactions and events. In this way, it improves the comparison of the various enterprises' reporting about operating performance.

- To know about the amount, timing and surety of future cash flows, historical information about cash flow is used. It is also helpful in checking the correctness of the past judgments of future cash flows. It also helps in determining the relationship between cash flow and profitability and the effect of inflation.

In this study, the matters relating to the cash flow statements, which normally forms a part of the financial statements of various enterprises to which the Accounting standard (AS) 3, 'Cash Flow Statements', become mandatory, is discussed in the light of, and on the basis of, the said Accounting Standard.

1.2.6 FORMAT OF THE CASH FLOW STATEMENT :

CASH FLOW STATEMENT AS PER AS – 3

	Rs.
<u>Cash flow from Operating Activities</u>	
Profit / (Loss) before taxation	√
<u>Add. :</u> Depreciation	√
<u>Add. :</u> Loss on disposal of non current assets	√
<u>Less :</u> Profit on disposal of non current assets	(√)
<u>Add. :</u> Finance Cost	√
<u>Less :</u> Investment Income	(√)
(increase) / Decrease in Inventories	(√)/√
(increase) / Decrease in Receivable	(√)/√
(increase) / Decrease in Trade Payables	√/(√)
(increase) / Decrease in Other Payables	√/(√)
<u>Less :</u> Taxation Paid	(√)
<u>Less :</u> Interest Paid	(√)

Net cash flow from operating Activities	√√√
<u>Cash flow from Investing Activities</u>	
<u>Add.</u> : Sales of non – current assets	√
<u>Less</u> : Purchase of non-current assets	(√)
<u>Add.</u> : Interest received	√
<u>Add.</u> : Dividends received	√
Net cash flow from Investing Activities	√√√
<u>Cash flow from Financing Activities</u>	
Proceeds from issue of shares	√
Proceeds from long term borrowings	√
Payments of finance lease liabilities	(√)
Redemption of Shares	(√)
Repayment of loans	(√)
Dividend Paid	(√)
Net Cash flow from Financing Activities	√√√
Net Cash Flow (total)	√√√
Cash and Cash Equivalent at the beginning	√√√
Cash and Cash Equivalent at the end	√√√

1.2.7 OPERATING ACTIVITIES :

- (1) To sustain the operating capacity of the organization, to pay dividends, to repay loans and to make new investments, the cash flow amounts raised from operating activities is considered as a key determinant to the extent to which the functions of the organization have created enough cash flows. This is done without carrying out the function of external financing sources. At the time of predicting future operating cash flow of an organization, information about historical operating cash flows as well as other information is very useful.
- (2) Cash flow from operating activities is obtained mainly from the activities based on principle revenue-production of an organization. Due to the various

transactions which are related with calculating net profit or loss, cash flow from operating activities arises.

Various examples of cash flow from operating activities are :

- (a) Cash received by selling the goods or by providing the services,
 - (b) Cash received as fees, royalties, commission and other incomes,
 - (c) Cash paid to the creditors for purchase of goods and other services,
 - (d) Cash paid to employees,
 - (e) Cash paid on behalf of the employees,
 - (f) Cash received for premiums of an insurance organization,
 - (g) Cash paid for claims, commissions and other administrative expenses of an insurance organization,
 - (h) If income-tax is not specifically considered with financing and investing activities, then payment of tax or refund of tax,
 - (i) If contracts are done for the purpose of dealing or trading, then cash received and cash paid related to Future contracts, Forward contracts, Option contracts and Swap contracts.
- (3) Profit or loss, on sale of any fixed asset or investments are considered as the transaction of calculating net profit or loss as it increases or reduces the profit or loss. However, such transactions are also considered as transactions of cash flow from operating activities.
- (4) Cash flow raised from the purchase and sale of trading or dealing the securities are also considered under the cash flow from operating activities because they are equal to inventory purchased especially for resale. In the same way, cash advances and loans given by the financial institutions are relating to the income producing activity of that organization. Therefore, they are also classified as the cash flow from operating activities.

1.2.8 INVESTING ACTIVITIES :

- (1) It is advisable for the organization to keep a record about how much expenditure have been made for purchase of assets and investments to create future cash flows. Therefore, it is important to keep separate disclosures of

cash flows raised from investing activities. Examples of cash flow raised from investing activities are:

- Cash paid for purchase of fixed assets, Cash paid for purchase of intangible assets, Cash paid for capitalized research and development, Cost of constructed fixed assets, Cash received from sale of fixed assets and Cash received from sale of intangible assets.
 - Cash paid to purchase shares, warrants and various debt instruments of other organizations, Interest in joint ventures (It does not include the payments for cash equivalent assets and assets held for the purpose of dealing or trading).
 - Cash received from the sale of shares, warrants and various debt instruments of other organizations, in joint ventures (It does not include the cash received for cash equivalent assets and assets held for the purpose of dealing or trading).
 - Payments of loans and advances in cash to the third parties (it does not include loans and advances made by a financial institution).
 - Receipts of loans and advances in cash from the third parties (it does not include loans and advances made of a financial institution).
 - If payments are not classified as financing activities and if contracts are not done for the purpose of dealing or trading, then cash paid for Future contracts, Forward contracts, Option contracts and Swap contracts.
 - If receipts are not classified as financing activities and if contracts are not done for the purpose of dealing or trading, then cash received from Future contracts, Forward contracts, Option contracts and Swap contracts.
- (2) If the contract is done for as a hedge of a position which is recognized, the cash flow of the contract is also divided in the same manner. They are also considered as the cash flow for as a hedge of position which is recognized.

1.2.9 FINANCING ACTIVITIES :

Cash flow from financing activities helps an organization in predicting future cash flows by providers of funds in the form of capital and borrowings. Therefore, it is advisable and important for an organization to keep a separate disclosure of cash flow from financing activities. Examples of cash flows raised from financing activities are:

- (a) Cash received from issue of shares and other securities and instruments.
- (b) Cash received from the issue of various instruments such as Debentures, Loans, Notes, Bonds, other short-term borrowings, other long-term borrowings etc.
- (c) Repayment of the amounts borrowed in cash.

1.2.10 REPORTING CASH FLOWS FROM OPERATING ACTIVITIES:

- (1) An organization can present the cash flow from operating activities by using any one of the following methods:
 - (a) The direct method - In this method, gross cash receipts and cash payments are reported in major groups.
 - (b) The indirect method – In this method, net profit or loss is calculated for giving the effects of various transactions such as:
 - Non-cash transactions
 - Transactions of past cash receipts and cash payments which may be deferred or accrual
 - Transactions of future cash receipts and cash payments which may be deferred or accrual
 - Transactions relating to cash flow from investing and financing activities and various incomes and expenses items of these activities.
- (2) The direct method for reporting cash flows from operating activities is considered superior than the indirect method. The main reason behind this is that the information provided under the direct method is very useful in predicting future cash flows. This information is not provided under the indirect method. Information about various groups of gross cash receipts and gross cash payments under the direct method can be obtained by using any one of the following ways:
 - (a) By using an organization’s accounting and financial records.

- (b) By adjusting various factors such as sales, interest incomes, other incomes, interest expenses, other expenses and other items in the profit and loss statement for various reasons such as:
 - Changes in the inventories, operating receivables and operating payables during a particular period;
 - Other items which are non-cash in nature;
 - Other items for which cash flows from investing and financing activities are having cash effects.

- (3) The net cash flow from operating activities under the indirect method is calculated by adjustment of net profit or loss for giving effects of various transactions such as:
 - (a) Changes in inventories, operating receivables and operating payables during the particular period;
 - (b) Depreciation, provisions, deferred taxes and unrealized foreign exchange profits and losses which are considered as non-cash items;
 - (c) All other transactions which are neither considered as investing nor as the financing activities' cash flows.

In another way, under the indirect method, cash flow from operating activities may also be reported. In this way, the operating incomes and way, the operating incomes and expenses are shown in the cash flow statements. But, non-cash items which are reported in the profit and loss statement and also the changes in the inventories, operating receivables and operating payables are excluded in this method.

1.2.11 REPORTING CASH FLOWS FROM INVESTING AND FINANCING ACTIVITIES :

Gross cash receipts and cash payments which arise from the investing and financing activities should be disclosed separately under the various groups by an organization. It does not include cash flows which are mentioned in cash flows on a net basis.

1.2.12 REPORTING CASH FLOWS ON A NET BASIS :

- (1) The cash flow which arises from the various operating, investing or financing activities should be reported on a net basis. Such activities include:

- (a) When the cash flow does not show the activities in the organization but it reflects the activities of the customer, then cash receipts and cash payments on behalf of the customers. Examples of such cash receipts and payments are:
 - Bank demand deposits accepted and repaid;
 - Funds which are held by an investment organization for customers;
 - Rent which is collected on behalf of the owners of properties and is paid over to them.
 - (b) Cash receipts and cash payments for various items which are having quick turnover, large amounts and short maturities. Examples of cash receipts and cash payments are:
 - Credit card customers related principal amounts;
 - The acquisition and sale of investments;
 - Other short-term borrowings which are having three months or less periods' maturity.
- (2) Cash flow of a financial organization which arises from any of the following activities should be reported on a net basis:
- (a) Cash received for the acceptance of the fixed deposits with a specific maturity date.
 - (b) Cash repaid of the fixed deposits with a specific maturity date.
 - (c) The putting of deposits in other financial organization.
 - (d) The withdrawal of deposits from other financial organization.
 - (e) Loans and advances given to the customer.
 - (f) Repayment of loans and advances by the customers.

1.2.13 FOREIGN CURRENCY CASH FLOWS :

- (1) In some transactions, cash flows are obtained in the form of foreign currency. These transactions should be recorded by converting them in the form of organization's reporting currency. This should be done by using the exchange rate between the foreign currencies and reporting currency on the date of cash flow.

If the exchange rates on the dates of cash flows were used, then a rate which is near to the actual rate should be used. What effect is occurred on the cash and cash equivalents due to the changes in the exchange rates that should be reported in the foreign currency? During a particular period, it should be done by using a separate part of the reconciliation of the variation in cash and cash equivalents.

- (2) There is a separate Accounting Standard (AS) – 11, “Accounting for the Effects of Changes in Foreign Exchange Rates”. Cash flows that are most powerful in foreign currency are recorded in a manner which is consistent to this AS-11. This Accounting Standard gives the permission to use an exchange rate which is very near to actual rate. For example, for recording transactions of foreign currency for a particular period, a weighted average exchange rate should be used.
- (3) Unrealized profits and losses which are raised due to the changes in foreign exchange rates are not considered as cash flows. However, there must be a separate report in the cash flow statement about the effects of changes in foreign exchange rate on the cash and cash equivalent which are held during a particular period.

This is done with a view to reconcile cash and cash equivalents at the starting and at the end of that period. There should be a separate reporting of such amounts from the cash flows from operating, investing and financing activities.

1.2.14 EXTRAORDINARY ITEMS :

- (1) The cash flow which is related to extraordinary items should be separately reported as whether it is raised from operating, investing or financing activities.
- (2) In the cash flow statement, the cash flows which are related to extraordinary items are separately reported as whether it is raised from operating, investing or financing activities. It helps the users in understanding the effects of their type on the present cash flow as well as on the future cash flow of the organization.

There is a separate disclosure about the type and amount of extraordinary items which is prescribed in the Accounting Standard (AS) – 5, “Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies”. The disclosures in the cash flow statement are in addition to the disclosures of this Accounting Standard.

1.2.15 INTEREST AND DIVIDENDS :

- (1) There should be a separate disclosure in the cash flow statement about the cash flow from receipt and payment of interest and dividend. In case of financial organization, cash flow which is raised from payment of interest and dividend should be considered as cash flow from operating activities. But, in case of other organizations:
 - Cash flows which arise from interest and dividend paid should be considered as cash flow from financing activities.
 - Cash flows which arise from interest and dividend received should be considered as cash flow from operating activities.
- (2) Interest paid may either be considered as expense in the profit and loss statement or it may be capitalized under the provisions of Accounting Standard (AS) -10 “Accounting from Fixed Assets”. However, in the cash flow statement the total amount of interest paid is recorded during the particular period.
- (3) In case of financial organizations, payment of interest and receipt of interest and dividends are considered as cash flow from operating activities. But, for the other organizations, there is no general view about the classification of these cash flows.

Some argue that payment of interest and receipt of interest and dividends are used for calculating net profit or loss and hence they should be considered as cash flow from operating activities. But, another view is that receipt of interest and dividend are cost of obtaining finance and return on investments.

- (4) Some argue that payment of dividend should be considered as the cash flows from operating activities. It is helpful to the users in knowing the capacity of the organization to pay dividends out of its operating cash flows. But, another argument is that the dividend paid is the cost of obtaining the finance from

outside. Therefore, dividend paid should be considered as the cash flows from financing activities.

1.2.16 TAXES ON INCOME :

- (1) If cash flows obtained from taxes on income are not considered specifically under the financing and investing activities, then it should be considered as cash flow from operating activities and should be separately disclosed in the cash flow statement.
- (2) In the cash flow statement, taxes on income which increases the cash flows are considered as cash flows from operating, investing or financing activities. But, tax expenses which reduce the cash flows are considered as cash flow from investing or financing activities in the cash flow statement.

Some cash flows relating to cash are sometimes impossible to recognize because they may arise in the different time periods from the cash flows of the transactions which are not obvious and are difficult to discover. Due to this reason, payments of taxes are generally considered as the cash flow from operating activities.

But, when it is impossible to recognize the tax cash flow which increases the cash flow, should be considered as cash flows from investing or financing activities as appropriate. When tax cash flows are divided between more than one types of activity, at that time the total tax paid amount is disclosed in the cash flow statement.

1.2.17 NON – CASH TRANSACTIONS :

- (1) The transaction in which cash or cash equivalents are not used is considered as non-cash transaction. Non-cash transactions of investing and financing activities should not be recorded in a cash flow statement. Such non-cash transactions should be recorded in other financial statements. These transactions should be presented in such a way that the users of the financial statements can get the information about investing and financing activities.

- (2) The capital and asset structure of an organization is affected by some investing and financing activities. But, transactions do not have a direct effect on current cash flows. The non-cash transactions are not included in the cash flow statement. It is connected with the object of a cash flow statement as these non-cash items do not include cash flows in the current period. Examples of non-cash transactions include:
- (a) The purchase of assets by predicting the directly connected liabilities.
 - (b) The purchase of an organization by issuing shares.
 - (c) The conversion of debt onto equity.

1.2.18 INVESTMENTS IN SUBSIDIARIES, ASSOCIATES AND JOINT VENTURES:

When an investor has done the investment in an association, a subsidiary or a joint venture, then its accounting should be done. An investor is not ready to report such investment in the cash flow statement to the cash flows between the organization and the investee or joint venture. For example, dividends and advances related cash flows.

1.2.19 ACQUISITIONS AND DISPOSALS OF SUBSIDIARIES AND OTHER BUSINESS UNITS :

- The total cash flows which arise from the purchase and sale of subsidiaries or other units of business should be reported independently. It should be recorded as investing activities in the cash flow statement.
- In any one of the following situations, an organization should present the total cash flows connected with purchase and sale of subsidiaries or business units:
 - (a) Consideration for the total purchase or sale in the form of cash and cash equivalents.
 - (b) Consideration for the partial purchase or sale in the form of cash and cash equivalents.
- The cash flow effects of purchase and sale of subsidiaries and other business units should be presented separately as items of single line. This helps in differentiating between these cash flows and other cash flows. The cash flow obtained from sale is not deducted from the cash outflow of purchases.

1.2.20 COMPONENTS OF CASH AND CASH EQUIVALENTS :

- In the cash flow statement, an organization should present the various parts of cash and cash equivalents. An organization should also present a reconciliation of the amounts of cash and cash equivalents with the amounts of equivalent items which are reported in the balance sheet.
- Due to the various practices of managing cash and in calculating the various parts of cash and cash equivalents, an organization should disclose the policy which it has adopted.
- There is an Accounting Standard (AS) – 5, “Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies”. If any change is occurred in the policy for calculating parts of cash and cash equivalents, its effect is recorded in the cash flow statement in accordance with this Accounting Standard.

1.2.21 OTHER DISCLOSURES :

- Some important amounts relating to cash and cash equivalents which are held by an organization, but they cannot be used by it. An organization should present these types of amounts into cash flow statement with the discussion of management.
- There are different situations in which balances of cash and cash equivalents are held by an organization but are not available them for use.

Example: It may happen that an organization which operates in a country where limits of exchange rate and other legal limits are applied. In such a situation, an organization, in spite of having cash and cash equivalents may not use these balances.

- To understand the liquidity and financial position of an organization, some additional information may be useful to the users of financial statements. An encouragement is given to the disclosure of such information with the discussion of management. Such disclosures include:

- (a) The borrowing facilities' amounts which are not drawn may be available for various operating activities in the future.
 - (b) To adjust the contracts that indicates the limits on the use of these facilities.
 - (c) The total amount of cash flows which indicates an increase in the operating capability separately from the other cash flows which are needed to sustain the operating capability.
- Such separate disclosure which discloses an increase in the operating capability also the cash flows which are required to sustain operating capability helps the users to decide whether an organization is investing properly in maintaining its operating capability. An organization that does not invest properly in maintaining its operating capability may lose its profit in the future if taking interest only in the current situation of liquidity and distribution system to owners.