

MANAGEMENT ACCOUNTING - CASH FLOW

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It is very important for a business to keep adequate cash in hand to meet day-to-day expenditures and to invest as and when required in business. Thus, cash plays a very vital role to run a business successfully. Sometimes it has been observed that in spite of adequate profit in business, they are unable to meet their taxes and dividends, just because of shortage of cash flow.

We have read about two very important financial statements: first, revenue statement and second, balance sheet. Revenue statements provide essential information about the operating activities of a concern, and balance sheets show the financial position of a firm. But, both are unable to convey anything about the generation of cash out of all business activities.

Keeping in view the above limitation, the financial accounting board, U.S.A., has emphasized on the need for a cash flow statement as:

“Financial reporting should provide information to help potential investors and creditors and other users in assessing the amounts, timing and uncertainty of prospective cash receipts from dividends or interest and proceeds from the sales, redemption or maturity of securities or loans. The prospects for those cash receipts of effected by an enterprises ability to generate enough cash to meet the obligation when due and its others operating needs to re-invest in operations and to pay cash dividends.”

In June 1995, the Securities and Exchange Board of India “SEBI” amended Clause 32 of the listing agreement requiring every listed companies to give along with the balance sheet and profit & loss account, a cash flow statement prepared in the prescribed format, showing cash flows from operating activities, investing activities and financing activities, separately.

Recognizing the importance of cash flow statement, The Institute of Chartered Accountants of India ICAI issued AS-3 revised Cash flow statements in March 1997. The revised accounting standards supersede AS-3 changes in financial position, issued in June 1981. The objectives of cash flow statement given in AS-3 Revised are as under:

“Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprises to generate cash and cash equivalents and the needs of the enterprises to utilize those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generations. The statement deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by mean of cash flow the statement which classified cash flow during the period from operating, investing and financing activities.”

During a specified period of time, a cash flow statement describes the inflows and outflows of the cash and cash equivalents in an enterprise. A cash flow statement shows the net effect of various business transactions on cash and cash equivalents and consideration of receipts and payments of cash. Cash flow is a summary of change in cash position in between the dates of two balance sheets and revenue statements. The important terms used in a cash flow statement are as follows:

Cash

The meaning of cash is cash in hand and cash at bank including deposits.

Cash and Cash Equivalents

Here, cash and cash equivalents imply readily convertible, highly liquid investments, the value of

which in cash is well-known to us without risk of change in its realization amount. The purpose of keeping cash equivalents is to meet our current and short-term commitment rather than for investments. Only those investments having short maturity terms qualify as cash equivalents. Short maturity means maturity within three months.

Cash Flows

There are two types of flows: inflows and outflows. If the increase in cash is the effect of transactions, it is called inflows of cash; and if the result of transactions is decrease in cash, it is called outflows of cash.

Note: If decrease in cash is due to cash management rather than its operating, investing, and financing activities, it will be excluded from cash outflows. Cash management means investment of cash in cash equivalents.

Classification of Cash Flows

According to AS-3 *Revised*, cash flows should be classified in three main categories:

- Cash Flow from operating activities
- Cash Flow from investing activities
- Cash Flow from financing activities

Cash flow from operating activities

Inflow of cash from operating activities represents the level of sufficient cash generation necessary to maintain operating capability without recourse to external resource of financing.

In other words, operating activities mean principal revenue-producing activities of a firm. It represents the transactions those determine the profit or loss of a firm.

Examples of cash Flows from operating activities:

- Cash sale *goods or services*
- Cash receipts from commission, fees and royalties income etc.
- Cash payments to workers or employees in form of salary or wages.
- Cash payments to supplier of goods or services.
- Cash receipt on account of insurance premium by insurance companies.
- Cash payments in form of claims, annuity and other benefits.
- Cash payments or refund of income tax in case not included in investing or financing activities.
- Cash payments on account of current and future contracts.

Note: Cash receipt on sale of plant and machinery comes under category of investing activities.

Cash flow from investing activities

Assets and long-term investments that do not come under cash equivalents are known as investing activities. Investing activity represents how much investment in long-term assets has been made to earn profit in future.

Examples of Cash Flows from investing activities:

- Cash payments to acquire tangibles and intangibles assets including construction of assets and capitalization of research and development cost.
- Cash receipts from sale of investments and disposal of fixed assets.
- Cash payment for investments in shares, warrants and debentures of other companies etc. excluding those which are covered under cash equivalents or purchased for trading purpose.

If so, those come under operating activities.

- Cash received from disposal of or sale of shares, warrants or redemption of funds other than those which are kept for trading purpose.
- Advances or loan made to third party other than by financing companies.
- Cash payment for future contracts other than trading purpose.
- Cash received from future contracts other than trading purpose.

Cash flow from financing activities

The activities which may result in change in size and composition of owner's capital including preference shares are called financing activities. Separate disclosure is important for financing activities.

Examples of Cash flows from financing activities include cash received on issue of shares, debentures, loans, bonds and other short- or long-term borrowings.

Cash payments on redemption of debentures bonds, preference shares etc.

Treatment of Some Typical Items

The treatment of some typical cash flow items is discussed below.

Extraordinary Items

Inflow or outflow of cash is classified according to the nature of activities that may be operating, investing, or financing activities. Cash flow due to extraordinary items should be shown separately in the cash flow statement to enable users to understand its nature and effect on the cash flow statement.

Interest and Dividends

If cash flow arises due to interest paid or interest and dividend received, then that should be classified as operating activities in case of "financial enterprises". In case of "other than financial organizations", the interest paid should be classified as financing activity, and the interest and dividends received should be classified as investing activity.

Note: Dividend paid should be classified as financing activity in both the above cases.

Taxes on Income

Taxes on income should be separately disclosed and should be classified under operating activities in most of the cases except where we can easily identify the taxes according to nature of income but if total amount of tax is given, then it should be classified as operating activities.

Note: Dividend distribution tax will be classified as financing activities.

Cash flows from acquisition and disposal of subsidiaries and other business units:

Cash flow arises due to acquisition or disposal of subsidiary should be shown separately and classified as investing activities. This transaction should be easily identifiable in cash flow statement to enable users to understand the effect of it. The cash flow of disposal is not deducted from cash flow of acquisition.

Foreign Currency

Items appearing in a cash flow statement should be shown in local currency value, applying actual foreign currency rate of the particular day on which cash flow statement is going to be prepared. Effect on value of cash and cash equivalents as reflected in the cash flow statement due to change in rate of foreign currency should be shown separately as a reconciliation of changes.

Due to change in foreign currency rate, unrealized gains and losses are not cash flows. However,

effect on cash and cash equivalents held or due in foreign currency are reported in cash flow statement in order to reconcile the cash and cash equivalents at the beginning and at the end of the period.

Non-Cash Transactions

Some investing and financing activities do not have any direct impact on cash flows. For example, conversion of debt to equity, acquisition of an enterprise by means of issuance of share, etc.

Those transactions should be excluded from cash flow statements, in which there are no use of cash or cash equivalents. There are other financial statements in which those investing and financing activities appear separately.

Format: *DirectMethod*

M/s ABC LIMITED

Cash flow Statement for the year ended 31 March 2014

Particulars	Amount
Cash Flows from Operating Activities <i>Schedule – 1</i>	XX
Cash Flows from Investing Activities <i>Schedule – 2</i>	XX
Cash Flows from Financing Activities <i>Schedule – 3</i>	XX
Extraordinary Items	XX
Net Profit before Tax	XX
Income Tax Paid	XX
Net Increase or Decrease in cash or cash Equivalents	XX
Add: Cash & Cash Equivalents at the beginning of the period	XX
Cash and Cash Equivalents at the end of the period	XXX

Schedule - 1

Cash flow from operating activities

Particulars	Amount
Cash received from customers	XXX
Cash paid for:	
- Suppliers for Purchases	XX
- Wages & Salary	XX
- Operating and General administrative expenses	XX XX
Net Profit before Taxes →	XX
Income Tax Paid →	XX
Cash flow from Operating Activities →	XXX

Schedule-2

Cash flow from investing activities

Particulars	Amount	
Cash received for:		
- Sale of Fixed Assets	XX	
- Sale of Investment	XX	
- Interest received	XX	
- Dividend received	XX	XXX
Cash paid for:		
- Purchase of Fixed Assets	XX	
- Purchase of Investments	XX	XX
Net Cash Flow from Investing Activities →	XX	

Schedule-3

Cash flow from financing activity

Particulars	Amount	
Cash received for:	XX	
Issue of Equity Shares	XX	
Issue of Preference Share	XX	
Long term borrowings	XX	XXX
Cash paid for:		
- Interest paid	XX	
- Redemption of preference shares	XX	
- Repayment of Loans	XX	
Dividend paid	XX	
Purchase of Investments	XX	XX
Net Cash Flow from Financing Activities →		<u>XX</u>

Cash Flow Indirect Method

- Two Balance Sheet requires.
- No need of Profit & Loss account in Indirect Method.
- Non Cash Item require.

- We need change in current Assets & Current Liabilities account.
- No need to open, Opening current assets and current Liabilities accounts.

Format

Indirect Method: Given by AS-3

M/s XYZ LIMITED

Cash flow Statement for the year ended 31 March 2014

Particulars	Amount
Cash Flows from Operating Activities <i>Schedule – 1</i>	XX
Cash Flows from Investing Activities <i>Schedule – 2</i>	XX
Cash Flows from Financing Activities <i>Schedule – 3</i>	XX
Extraordinary Items	XX
Net Profit before Tax →	XX
Income Tax Paid →	XX
Net Increase or Decrease in cash or cash Equivalents →	XX
Add: Cash & Cash Equivalents at the beginning of the period →	XX
Cash and Cash Equivalents at the end of the period →	XXX

Schedule-1

Cash flow from operating activities

Particulars	Amount
Changes in Profit & Loss account	XX
Changes in Reserve <i>Any</i>	XX
+ Interim Dividend	XX
Net Profit →	XXX
Non Cash Items:	
+ Depreciation	XX
+ Loss on Sale of Fixed Assets	XX
+ Goodwill Amortization	XX
+ Preliminary Expenses written off	XX
Non Cash Incomes:	
– Gain on Sale of Fixed Assets	XX
Operating Profit before working Capital changes →	XXX

± Changes in Current Assets & Current liabilities	XX
Cash operating Expenses before Tax	-----
Tax Paid	XXX
	X
Cash Flow from Operating Activities →	-----
	XXX

Schedule-2

Cash flow from investing activities

Particulars	Amount
Cash received for:	
- Sale of Fixed Assets	XX
- Sale of Investment	XX
- Interest received	XX
- Dividend received	XX XXX
Cash paid for:	
- Purchase of Fixed Assets	XX
- Purchase of Investments	XX XX
Net Cash Flow from Investing Activities →	XX

Schedule-3

Cash flow from financing activity

Particulars	Amount
Cash received for:	
- Issue of Equity Shares	XX
- Issue of Preference Share	XX
- Long-term borrowings	XX XXX
Cash paid for:	
- Interest paid	XX
- Redemption of Preference shares	XX
- Repayment of Loans	XX

- Dividend paid	XX	
- Purchase of Investments	XX	XX
Net Cash Flow from Financing Activities →	XX	

Processing math: 100%