# Unit-5 □ Analysis of Cash Flow Statement

**Structure**



## 5.1 Introduction

The nerve centre of any business is its cash reserves. It is critical to the smooth functioning of a firm. Excess of such reserves may make the firm less profitable as idle cash yields no return while shortfall in cash may eventually lead the firm to bankruptcy. So, there is a need to carry an optimum balance of cash always. That is, when cash flows into the business at a much faster pace than it is being disbursed, the company's manager must seek some temporary investment outlets for the accumulated excess cash reserves. On the other hand, in times of cash deficit the company must make arrangements for raising the required amount from outside sources. It must however be noted that the above steps can be taken by the management only if they are aware of the movement of cash of the business during the accounting period. Thus, a detailed analysis of cash flow position of a firm is necessary to equip the management with the information about cash flows during a period.

The traditional accounting statements such as income statement and balance sheet, and even fund flow statement may fail to present a clear picture of the cash flows of the business. The traditional accounting statements are prepared on accrual basis and so may consider several non-cash items of revenues (e.g. accrued income etc.) and expenses (e.g. depreciation etc.) while determining profit of the business. As a result, a situation may arise where the accounting statements say that the firm is operating profitably, yet, in reality, the firm finds it difficult to meet its commitments like payment of wages, taxes, debt interest, dividend etc. Because of the inclusion of several non-cash items in accounting profit, the actual cash surplus may be far less than the profit earned during

the period in such situations. Again, fund flow statement is incapacitated to project a firm's cash flow position because of the following reasons. Firstly, what constitutes a fund is, in itself, an ambiguous matter. There are several concepts of fund and hence the users of financial statements, who have no technical knowledge of accounts, cannot clearly understand the meaning of the term 'fund'. Secondly, of all the concepts, the working capital concept of fund has gained popularity in business. But working capital concept may give a misleading picture of cash flow position of a firm. As for example, working capital may be increased even by accumulating obsolete stock but such a practice would be detrimental to cash reserves of the firm. Thirdly, as cash is merged with working capital, fund flow statement actually obstructs the flow of information on cash resources rather than disclosing it. As a result, fund flow statement cannot provide a warning signal regarding an impending sickness of a firm. Because of the above-mentioned limitations of the traditional accounting statements, the need to prepare a separate statement focusing solely on cash flows during a particular period has arisen.

The following sections thus discuss the meaning of cash flows and cash flow statement, mode of preparing the cash flow statement, role and utility of cash flow statement in detail.

## 5.2 Meaning of Cash Flows and Cash Flow Statement

*Cash flows* of a business mean inflows and outflows of 'cash' and 'cash equivalents'. 'Cash' comprises cash in hand and at bank and demand deposits (i.e., deposits which are payable on demand). 'Cash equivalents' are short-term highly liquid investments that are readily convertible into known amounts of cash and are subject to insignificant risk of changes in value. Such cash equivalents are primarily held by a firm for the purpose of meeting its short-term cash commitments. The cash flow statement of a firm is prepared on the basis of this 'cash and cash equivalents' concept.

A *cash flow statement* shows the changes in financial position of a firm on cash basis. In other words, it shows the net effect of the various transactions of a firm during a period on cash and explains the causes of changes in the cash position of a firm between two balance sheet dates. Thus the cash flow statement analyses changes in non-current accounts as well as current accounts (other than cash) to determine the various sources (like decrease in assets, increase in liabilities, profit from operations, issue of securities etc.) and applications (like loss from operations, increase in assets, decrease in liabilities, redemption of securities etc.) of cash during a period and their net impact on the cash balance.

## 5.3 Preparation and Interpretation of Cash Flow Statement

In India, the Companies Act, 1956 has not mandated the preparation of cash flow statement as forming a part of financial statements of a company. But accounting standard–3 (AS-3) issued by The Institute of Chartered Accountants of India has made it compulsory for—

(a) listed companies or companies whose shares and debentures are in the process of enlisting on a recognized stock exchange in India, and

(b) all other commercial, industrial and business enterprises whose turnover for the accounting period exceeds Rs.50 crore.

To prepare cash flow statement for each accounting period commencing on or after 1st April, 2001. The cash flow statement, thus prepared, must also be audited for the purpose of annexing it to the financial statements.

AS-3 prescribes the format for the preparation of cash flow statement. As per the standard, a cash flow statement is to be classified into three heads i.e. cash flows from :

(i) operating activities,

(ii) investing activities, and

(iii) financing activities.

Operating activities involve income-determining items i.e., revenues and expenses, and changes in current assets and current liabilities. Investing activities relate to changes in non-current assets i.e., fixed assets and investments. Financing activities relate to changes in non-current liabilities i.e., loans, debentures etc. and stockholders' equity. However, under AS-3, cash flows arising due to interest payment and receipt of interest and dividend should be classified as cash flows from operating activities in case of a financial company. But in case of other companies, interest payment should be shown under financing activities while interest and dividend received should be shown under investing activities. Dividend payment should, however, be shown under financing activities in all the cases.

The cash flow statement for an accounting period can be prepared by taking the help of opening and closing balance sheets, profit and loss account and other relevant information obtained from the accounting records of the company for that period. The starting point of the cash flow statement is net income (after taxes) as per the income statement which is determined under accrual basis of accounting. Thus net income figure is adjusted for non-cash items like depreciation etc., interest (in case of a finance company, interest paid is not deducted from net income as it is considered as a part of operating cash flows) and taxes, non-operating and extraordinary items of income (like

interest and dividend income etc. although, in case of a finance company, such interest and dividend income are considered as a part of operating cash flows) and expense (like foreign exchange loss etc.) appearing in the income statement to convert it into cash operating profit. Thereafter, adjustments are made to cash operating profit in respect of changes in current assets and current liabilities during the period and for tax paid in order to arrive at cash generated by operating activities.

Capital expenditures for long-term assets (i.e., fixed assets) like property, plant and equipment are usually the primary component of investing cash flows. Such capital expenditures are calculated net of proceeds on sale of these assets and hence investing cash flows usually denote net cash outflows from investing activities. Investing cash flows also include cash flows arising out of investments in or collection of principal value of investments in joint ventures, affiliates and other companies' securities. In case of companies other than a finance company, interest and dividend income are a part of investing cash flows of the firm.

Components of financing cash flows include inflows from additional borrowings (both short-term and long-term) and equity financing, and outflows for repayment of debt, dividend payment and equity repurchases. Other than finance companies treat interest payment on debt as a cash outflow under financing activities.

Once the cash flows under each of the three different heads have been separately computed, the next step is to find out the aggregate/net cash flows from operating, investing and financing activities. Since the three kinds of cash flows consider changes in each and every items of balance sheet excepting cash, the aggregate/net cash flows, as computed above, must equal the change in cash balance between opening and closing balance sheet dates. This identity provides a check on computations.

As per AS-3, non-cash items, whether falling under operating, investing or financing activities, should be disclosed by way of footnotes to the cash flow statement and not as a part of the statement itself. The proforma cash flow statement under AS-3 is shown below.

**CASH FLOW STATEMENT OF ..... LTD.**

*FOR THE PERIOD .....*

| PARTICULARS | Amount (Rs.) | Amount (Rs.) | Amount (Rs.) |
|---|---|---|---|
| Operating Cash Flows (OCF) : | | | |
| Net Income as per Profit & Loss Account | | ×××× | |
| Add/Less: Adjustments for non-cash items, non-operating and extraordinary income and expenses : | | | |

| PARTICULARS | Amount (Rs.) | Amount (Rs.) | Amount (Rs.) |
|---|---|---|---|
| (+) Depreciation | xxxx | | |
| (+) Foreign exchange loss | xxxx | | |
| (+) Loss on sale of fixed assets/ investments. | xxxx | | |
| (+) Loss/premium on redemption of capital. | xxxx | | |
| (+) Tax paid | xxxx | | |
| (+) Interest expense (not added back in case of a finance company) | xxxx | | |
| (-) Profit on sale of fixed assets/ investments | (xxxx) | | |
| (-) Profit/discount on redemption of capital | (xxxx) | | |
| (-) Interest income (not deducted in case of a finance company) | (xxxx) | | |
| (-) Dividend income (not deducted in case of a finance company) | (xxxx) | | |
| | | xxxx | |
| OCF before working capital changes | | xxxx | |
| Add/Less : Adjustments for changes in working capital | | | |
| (+) Decrease in current assets (excluding cash) | xxxx | | |
| (+) Increase in current liabilities | xxxx | | |
| | xxxx | | |
| (-) Increase in current assets (other than cash) | (xxxx) | | |
| (-) Decrease in current liabilities | (xxxx) | xxxx | |
| OCF after working capital changes | | xxxx | |
| (-) Tax paid | | xxxx | |
| Net Cash Flows from Operating Activities | | | xxxx |
| Add : Financing Cash Flows (FCF) | | | |
| Issue of shares/debentures | xxxx | | |
| (+) Raising of loan (short-term as well as long-term) | xxxx | | |
| | | xxxx | |

| PARTICULARS | Amount (Rs.) | Amount (Rs.) | Amount (Rs.) |
|---|---|---|---|
| (-) Redemption of preference shares and debentures. | xxxx | | |
| (-) Repurchase of equity shares | xxxx | | |
| (-) Repayment of loan | xxxx | | |
| | | (xxxx) | |
| | | xxxx | |
| (-) Interest expenses on debt (in case of other than finance companies) | xxxx | | |
| (-) Dividend paid to shareholders | xxxx | | |
| | | xxxx | |
| Net Cash Flows from Financing Activities | | | xxxx |
| | | | xxxx |
| Less: Investing Cash Flows (ICF) | | | |
| Purchase of fixed assets and investments | xxxx | | |
| (+) Loans to other companies | xxxx | | |
| | | xxxx | |
| (-) Sale of fixed assets and investments | xxxx | | |
| (-) Collection of principal value of loans to other companies | xxxx | | |
| | | xxxx | |
| (-) Interest and dividend income (in case of other than finance companies) | | xxxx<br>(xxxx) | |
| Net Cash Flows from Investing Activities | | | (xxxx) |
| Net Increase/(Decrease) in cash balance | | | xxxx |
| Add : Cash and cash equivalents as at opening balance sheet date | | | xxxx |
| Cash and cash equivalents as at closing balance sheet date | | | xxxx |

**Notes :** List of individual non-cash items under operating, financing and investing activities.

However, mere preparation of the cash flow statement as per AS-3 is not sufficient to determine the financial position of a firm. In order to find out whether – the company

can avail additional credit from its suppliers; the customers are taking more or less time in clearing their dues; the company can raise cash by selling some investments to prevent the disruption of operations; the company can support its expansion programme out of the available funds and current operations or need to raise new debt or equity for the purpose etc., the cash flow statement needs to be analysed further with the help of few ratios.

In order to interpret the cash flow statement, the following four categories of cash-flow based ratios are computed.

(a) *Coverage Ratios* :

(i) $$\text{Interest Coverage Ratio} = \frac{\text{Operating Cash Flows (OCF)}}{\text{Interest}}$$

(ii) $$\text{Dividend Coverage Ratio} = \frac{\text{Operating Cash Flows (OCF) Interest}}{\text{Dividend}}$$

(iii) $$\text{Debt Coverage Ratio} = \frac{\text{OCF-Interest-Dividend}}{\text{Total Debt}}$$

The above coverage ratios indicate the cash flow coverage for dividend, interest and debt paying ability of a firm as provided by its operating activities.

(b) *Quality of Income Ratios :*

These ratios indicate the percentage of total revenue or total earnings that has been realized in cash in any particular accounting period. The following two kinds of ratios may be calculated under this head—

(i) $$\text{Quality of Sales Ratio} = \frac{\text{Sales converted into cash}}{\text{Total Sales}} \times 100$$

(ii) $$\text{Quality of Profit Ratio} = \frac{\text{OCF}}{\text{Operating Profit (or EBDIT)}} \times 100$$

(c) *Capital Expenditure Ratios :*

These ratios measure the degree of dependence of a firm on internal and external funds for its capital expenditure as follows :

(i) $$\text{Degree of dependence on internal funds for capital expenditure} = \frac{\text{OCF} - \text{Increase in cash Balance between two Balance sheet dates}}{\text{Investing Cash Flows (ICF)}} \times 100$$

(ii) $$\text{Degree of dependence on external funds for capital expenditure} = \frac{\text{Financing Cash Flows (FCF)}}{\text{Investing Cash Flows (ICF)}} \times 100$$

(d) ***Cash Return Ratios :***

These ratios are, in effect, cash-flow based profitability measures and are of the following types :

(i) $$\text{Cash return on Total Assets} = \frac{\text{OCF}}{\text{Total Assets}} \times 100$$

(ii) $$\text{Cash Return on Net Worth} = \frac{\text{OCF} - \text{Interest}}{\text{Net Worth}} \times 100$$

(iii) $$\text{Cash Flow per Share} = \frac{\text{OCF} - \text{Interest}}{\text{Number of Shares}}$$

The following illustration will make it clear as to how to interpret a cash flow statement based on the above-mentioned ratios.

**Illustration :**

**Problem (1) :** From the following balance sheets and additional information of X Ltd., prepare a cash flow statement under AS-3 and analyse it.

**BALANCE SHEETS**

| Liabilities | 31.03.04 | 31.03.05 | Assets | 31.03.04 | 31.03.05 |
|---|---|---|---|---|---|
| Equity Share | | | Fixed Assets | 10,00,000 | 12,00,000 |
| Capital of Rs.10 | | | Stock | 4,00,000 | 3,00,000 |
| each fully paid | 6,00.00 | 9,00,000 | Debtors | 2,00,000 | 3,00,000 |
| Profit and Loss | | | Cash | 1,00,000 | 2,00,000 |
| Appropriation A/c | 2,00,000 | 4,00,000 | | | |
| 10% Debentures | 6,00,000 | 5,00,000 | | | |
| Creditors | 3,00,000 | 2,00,000 | | | |
| | 17,00,000 | 20,00,000 | | 17,00,000 | 20,00,000 |

Additional Information (during the period 2004-2005) :

(i) Debentures were redeemed at 10% premium.

(ii) Depreciation charged on fixed assets amounted to Rs. 1,00,000/-

(iii) Equity shares issued at par for acquisition of fixed asset Rs. 50,000/-

(iv) Fixed assets costing Rs. 10,000/-, book value Rs. 5,000/- was sold for Rs. 15,000/-

(v) Dividend paid – Rs. 45,000/-

**Solution :**

## CASH FLOW STATEMENT OF X LTD. (UNDER AS-3)

*FOR THE PERIOD 2004-2005*

| Particulars | Amount (Rs.) | Amount (Rs.) | Amount (Rs.) |
|---|---|---|---|
| Operating Cash Flows (OCF) : | | | |
| Net Income after dividend as per profit and loss appropriation a/c Rs. (4,00,000 – 2,00,000) | | 2,00,000 | |
| Add back : Dividend | 45,000 | | |
| Interest (Note 5) | 50,000 | | |
| Depreciation | 1,00,000 | | |
| Premium on redemption of 10% debentures (Note 1) | 10,000 | | |
| | | 2,05,000 | |
| | | 4,05,000 | |
| Less : Profit on sale of fixed assets (Note 3) | | 10,000 | |
| OCF before working capital changes | | 3,95,000 | |
| Add : Decrease in current assets (other than cash)— | | | |
| Stock (Rs. 4,00,000 – Rs. 3,00,000) | 1,00,000 | | |
| Increase in current liabilities | NIL | | |
| | | 1,00,000 | |
| | | 4,95,000 | |
| Less : Increase in current assets— | | | |
| Debtors (Rs. 300000 – Rs. 200000) | 1,00,000 | | |
| Decrease in current liabilities— | | | |
| Creditors (Rs. 300000 – Rs. 200000) | 1,00,000 | | |
| | | 2,00,000 | |
| Net Cash Flows from Operating Activities : | | | 2,95,000 |
| Add : Financing Cash Flows (FCF) | | | |
| Issue of equity shares (Note 4) | 2,50,000 | | |
| Less : Redemption of 10% debentures (Note – 1) | 1,10,000 | | |
| | 1,40,000 | | |

| Particulars | Amount (Rs.) | Amount (Rs.) | Amount (Rs.) |
|---|---|---|---|
| Less : Interest on 10% debentures (Note-5) | 50,000 | | |
| Payment of dividend [assuming that X Ltd. is not a finance company] | 45,000 | | |
| | | 95,000 | |
| Net Cash Flows from Financing Activities | | | 45,000 |
| | | | 3,40,000 |
| Less : Investing Cash Flows (ICF) | | | |
| Purchase of fixed assets (Note 2) | | 2,55,000 | |
| Less : Sale of fixed assets (Note 3) | | 15,000 | |
| Net Cash Flows from Investing Activities | | | 2,40,000 |
| Net Increase in Cash Balance | | | 1,00,000 |
| Add : Opening Cash Balance | | | 1,00,000 |
| ∴ Closing Cash Balance | | | 2,00,000 |

Footnotes :

(1) Depreciation charged on fixed assets for the period 2004-2005 is Rs. 1,00,000.

(2) Rs. 50,000/- worth equity shares issued at par for acquisition of equivalent amount of fixed assets.

Workings :

(1) Premium on redemption of debentures at 10%—

Face value of 10% debentures redeemed = Rs. 1,00,000

(Rs. 6,00,000 – Rs. 5,00,000)

∴ 10% premium thereof (10/100 × 1,00,000) = Rs. 10,000

∴ Total Redemption value of debentures = Rs. (1,00,000 + 10,000) = Rs. 1,10,000/-

(2) FIXED ASSETS A/C

*Dr.* *Cr.*

| Particulars | Amount (Rs.) | Particulars | Amount (Rs.) |
|---|---|---|---|
| To Balance b/f | 10,00,000 | By Depreciation A/c | 1,00,000 |
| To Equity share capital (issue against acquisition) | 50,000 | By Cash A/c (book value sold Note 3) | 5,000 |
| To Cash A/c (purchase—balancing figure) | 2,55,000* | By Balance c/d | 12,00,000 |
| | 13,05,000 | | 13,05,000 |

(3) Profit on sale of fixed assets—

| | | |
|---|---|---|
| Sale proceeds realized in cash | = | Rs. 15,000* |
| (-) Book value of fixed assets sold | = | Rs. 5,000 |
| ∴ Profit on sale of fixed assets | = | Rs. 10,000 |

(4) EQUITY SHARE CAPITAL A/C

*Dr.* *Cr.*

| Particulars | Amount (Rs.) | Particulars | Amount (Rs.) |
|---|---|---|---|
| To Balance c/d | 9,00,000 | By Balance b/f | 6,00,000 |
| | | By Fixed Assets A/c | 50,000 |
| | | By Cash A/c (new issue) | 2,50,000* |
| | 9,00,000 | | 9,00,000 |

(5) Interest on outstanding 10% debentures (Assuming Rs.10,000 face value of 10% debentures has been redeemed as at 01.04.2004)

$$= \frac{10}{100} \times (5,00,000)$$

= Rs. 50,000

**Ratios for interpretation of cash flow tatement :**

(a) ***Coverage Ratios :***

(i) Interest Coverage Ratio

$$= \frac{\text{OCF}}{\text{Interest}}$$

$$= \frac{\text{Rs. 2,95,000}}{\text{Rs. 50,000}} = 5.9 \text{ times}$$

(ii) Dividend Coverage Ratio

$$= \frac{\text{OCF - Interest}}{\text{Dividend}}$$

$$= \frac{\text{(Rs. 2,95,000 – Rs. 50,000)}}{\text{Rs. 45,000}}$$

= 5.4 times

(iii) Debt Coverage Ratio

$$= \frac{\text{OCF – Interest – Dividend}}{\text{Total Debt}}$$

$$= \frac{\text{Rs. (2,95,000 – 50,000 – 45,000)}}{\text{Rs. 5,00,000}}$$

= 0.4 times

(b) ***Quality of Income Ratios :***

(i) Quality of Profit Ratio $= \frac{\text{OCF}}{\text{EBDIT}} \times 100$

where EBDIT = Earnings before depreciation, interest and taxes (and ofcourse dividend and non-operating items)

= Rs. (2,00,000 + 1,00,000 + 50,000 + 45,000 + 10,000 – 10,000)

= Rs. 3,95,000

$\therefore$ Quality of Profit Ratio $= \frac{\text{Rs. } 2,95,000}{\text{Rs. } 3,95,000} \times 100$

$= 74.7\%$

(c) ***Capital Expenditure Ratios :***

(i) Degree of dependence on internal funds for capital expenditure $= \frac{(\text{OCF} - \text{Increase in cash balance})}{\text{ICF}} \times 100$

$= \frac{\text{Rs. } (2,95,000 - 1,00,000)}{\text{Rs. } 2,40,000} \times 100$

$= 81.25\%$

(ii) Degree of dependence on external funds for capital expenditure $= \frac{\text{FCF}}{\text{ICF}} \times 100$

$= \frac{\text{Rs. } 45,000}{\text{Rs. } 2,40,000} \times 100$

$= 18.75\%$

(d) **Cash Return Ratios :**

(i) Cash Return on Total Assets $= \frac{\text{OCF}}{\text{Total Assets}} \times 100$

$= \frac{\text{Rs. } 2,95,000}{\text{Rs. } 20,00,000} \times 100$

$= 14.75\%$

(ii) Cash Return on Net Worth $= \frac{\text{OCF} - \text{Interest}}{\text{Net Worth}} \times 100$

where Net Worth = Equity Capital + Profit & Loss Appropriation balance

= Rs. (9,00,000 + 4,00,000)

= Rs. 13,00,000

$$\therefore \text{ Cash return on Net Worth} = \frac{\text{Rs. } (2,95,000 - 50,000)}{\text{Rs. } 13,00,000} \times 100$$

$$= 18.85\%$$

$$\text{(iii) Cash Flow per Share} = \frac{\text{OCF} - \text{Interest}}{\text{No. of Shares}}$$

$$= \frac{(\text{Rs. } 2,95,000 - \text{Rs. } 50,000)}{\text{Rs. } 90,000}$$

$$= \text{Rs. } 2.72/\text{share}$$

**Interpretation of Ratios :**

Interest coverage ratio of 5.9 times and dividend coverage ratio of 5.4 times appear to be comfortable and debt coverage ratio of 0.4 times signifies that 40% of total debt can be redeemed at once from the internal funds. This position also seems to be comfortable.

Quality of profit ratio of 74.7% implies that 74.7% of operating profit is realized in cash. This proportion is not very high and efforts should be made to convert operating profit into cash profit in higher proportion.

Dependence on internal funds for capital expenditure to the tune of 81.25% is quite high.

The return ratios show that cash return on net worth and cash flow per share are satisfactory at 18.85% and Rs.2.72/share respectively. However, this position can be improved if cash return on total assets, which presently stands at 14.75% is improved further.

The overall position of the company on the basis of cash flow information seems to be satisfactory. But efforts should be made to improve the quality of profit ratio and cash return on total assets. However, as information on results of other firms in the industry is not available, any definite conclusion regarding the performance of X Ltd. cannot be drawn.

## 5.4 Role of Cash Flow Statement

Cash flow statement supplements the information provided by the income statement and balance sheet as it links the two consecutive balance sheets. The primary purpose of a cash flow statement is to provide information on all cash receipts and payments (classified among operating, investing and financing activities) of the firm for a specified period and their impact on the ending cash balance. It also discloses that period's non-cash investing and financing activities.

The classification of cash flows among operating, financing and investing activities is essential to the analysis of cash flow data. This is because net cash flows i.e., change in cash and cash equivalents during a period has little informational content by itself; it is the classification and individual components that are informative.

The cash flow statement is thus intended to help predict the firm's ability to sustain (and increase) cash from its current operations for its long-term survival and growth and hence present a true picture of the firm's liquidity and solvency position. In doing so, the cash flow statement provides more objective information about—

- a firm's ability to generate cash out of production and sale of goods and services;
- the capacity of a firm to meet its obligations like payment of wages, expenses, interest, taxes etc. and pay dividends;
- the amount of cash used up to acquire fixed assets, investments and other businesses in order to maintain a firm's current operating capacity and to provide capacity for future growth;
- the amount of cash received from sale or disposal of fixed assets, investments as well as segments of the business;
- the cash flow consequences of the firm's financing decisions i.e., capital structure (debt-equity mix) decisions like issue of shares, repurchase of equity, incurrence and repayment of debt etc., and dividend policy decisions i.e., returns to shareholders in the form of dividends;
- trends in each of the above cash flow components;
- the extent of increase or decrease in cash during any period and hence the amount of ending cash balance, and
- the difference between net profit and net cash flows from operations.

## 5.5 Utility of Cash Flow Statement

The usefulness of cash flow statement to different users of published accounting data hardly needs any emphasis. The statement of cash flows gives an indication of the firm's operating, financing and investment policies followed by its management in the past. As the statement discloses the various sources and applications of cash during a period and their impact on the ending cash balance, it gives a clear picture of the causes of changes in the company's working capital or cash flow position and their resultant impact on the firm's liquidity position. The statement also reveals the non-current assets acquired by the company, the manner in which they have been financed from internal and external sources, the extent to which the firm's working capital needs have been met out of funds

generated from current operations or out of external sources of finances, the ability of the firm to pay its long term debt as per schedules and the like. Thus, the cash flow statement is a post-mortem analytical tool that helps the management to assess the company's strengths and weaknesses to withstand unexpected pressure on cash in future arising either due to a sudden fall in operations or due to an abnormal demand for cash.

However, the historical cash flow statement is not sufficient to meet the needs of the users. It must provide insights to prepare reliable cash flow (both inflows and outflows) projections for the immediate future in order to determine the availability of cash. The users base their decisions to continue their relationship with the firm on such projected cash flow statement.

A projected cash flow statement helps the *management* in the area of financial planning (both short-run and long-term) and control. The cash balance as per projected cash flow statement enables the management to match it with the firm's short-term cash needs to meet its maturing debt, interest, dividend and various expenses and hence identify the excess/shortfall of cash in the near future. This, in turn, will help the management to take short-term investment decisions in case of expected cash surplus or make arrangements for procuring the amount of shortfall from appropriate sources for meeting the expected commitments of the firm. The projected cash flow statement also aids the management in long-term planning. The estimates of working capital over a longer period, say five to ten years, help management to plan for repayment of long-term debt, acquisition of fixed assets and the like. If the firm needs working capital for expansion, which cannot be ordinarily provided from its operations, then it can plan the sources from where to procure the required funds on a long-term basis.

The cash flow statement is also useful to the *investors*. As the existing shareholders are particularly interested in the present value of future streams of cash flows in the form of dividend and capital appreciation, which, in turn, is closely related to cash flow generating capacity of a firm, the cash flow statement is expected to serve their needs. A prospective investor is more interested in projected cash flow statement not only for determining the profitability of the firm where he intends to invest but also for ensuring that his investment would earn regular return in future.

The *creditors, lenders, bankers* and *financial institutions*, both existing and potential, are also found to use the cash flow statement, as well as the projected one, to determine the liquidity position of the firm and its ability to pay interest regularly and repay the principal before extending their relationship with the firm.

Cash flow statement based ratios also act as good predictors of an impending failure of a company.

Thus, in conclusion it may be said that neither the statement of cash flows nor the income statement alone contains sufficient information for decision making. Income statement and balance sheet data must be combined with cash flow data for insights into the firm's ability to turn its assets into cash inflows, repay its liabilities and generate positive returns to shareholders. All the three financial statements are needed to value the firm appropriately.

## 5.6 Select Readings


- Banerjee, B., *Financial Policy and Management Accounting*, Prentice Hall of India Pvt. Ltd., New Delhi, 2005.
- Pandey, I.M., *Financial Management*, Vikas Publishing House Pvt. Ltd., 1999.
- White, Sondhi & Fried, *The Analysis and Use of Financial Statements*, John Wiley & Sons, 2003.


## 5.7 Questions

**Long – Answer type :**

(1) Discuss the usefulness of cash flow statement.

(2) How would you prepare a cash flow statement under Indian Accounting Standard – 3?

(3) Given the following balance sheets of Y ltd.

**BALANCE SHEETS**

| Liabilities | 31.03.04 | 31.03.05 | Assets | 31.03.04 | 31.03.05 |
|---|---|---|---|---|---|
| Share capital of | | | Land | 16,000 | 36,000 |
| Rs.10 each | 80,000 | 60,000 | Equipment | — | 32,000 |
| Retained earnings | 8,400 | 18,800 | *Less :* Accumulated | | |
| Bonds payable | — | 18,000 | depreciation | | (3200) |
| Income tax payable | — | 2,400 | Inventory | 32,000 | 26,000 |
| Outstanding expenses | 4,000 | 3,000 | Sundry debtors | 3,000 | 2,400 |
| Sundry creditors | 12,000 | 10,400 | Prepaid expenses | 1,600 | 1,200 |
| | | | Cash and Bank | 31,800 | 38,200 |
| | 84,400 | 1,32,600 | | 84,400 | 1,32,600 |

*Additional Information :*

(i) Net profit for the year 2004-2005 – Rs. 16,800.

(ii) Dividend declared and paid for 2004-2005 – Rs. 6,400.

(iii) Provision for tax – Rs. 7,200.

(iv) Equipment worth Rs. 36,000 purchased at the beginning of the period. Equipment costing Rs. 4000 was sold for Rs. 3400 (book value Rs. 3,600).

(v) Total depreciation on equipment for the period – Rs. 3,600.

(vi) Bonds issued at par in cash.

(vii) Shares of Rs. 20,000/- issued to acquire land.

Prepare a cash flow statement under AS-3 and comment on the performance of Y Ltd. on the basis of cash flow statement.

**Short – Answer Type :**

(4) Why is it necessary to prepare a separate statement of cash flows in addition to preparing the traditional accounting statements?

(5) What information does a cash flow statement convey?

(6) Explain the various cash return ratios and quality of income ratios.

**Objective Type :**

(7) State whether the following are true or false

(a) 'Cash' as per AS-3 in cash flow statement includes only cash in hand and at bank.

(b) The preparation of cash flow statement under AS-3 is mandatory for all companies.

(c) Investing cash flows relate to cash inflows and outflows arising out of changes in non-current assets while the cash flows relating to changes in non-current liabilities are termed as financing cash flows.

(d) Interest and dividend income are a part of OCF in case of a finance company but a part of ICF in case of other companies as per AS-3.

(e) Dividend payment is always considered as a part of FCF under AS-3.

[Hints : (7) (a) False; (b) False; (c) True; (d) True; (e) True]