Diploma in Financial Management & Accountability

- a joint initiative of TISS & FMSF

Course Material

Budgeting & Monitoring

Paper - IV

Unit -5

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UNIT- 5
STATEMENT OF CASH FLOWS

5.1. INTRODUCTION:

The Cash Budget reflects projected cash and bank receipts and payments and cash / bank equivalents such as short term fixed deposits with the bank and the balance being the cash and bank balance in hand. Essentially the cash budget shows future cash inflows and cash outflows. Cash budgets usually include both operating and non-operating transactions. It includes outflow on recurring and capital items. A cash budget identifies possible cash shortages and overages. Shortages may require borrowing. Overages may mean there is extra money available to invest for a return. The cash budget also indicates if anticipated cash resources are adequate to finance operations. If not, external financing may be needed for which the budget estimates the amount and timing.

The cash budget focuses on short-term cash flows including receipts, disbursements, loans, repaying debt, and purchases. Expenditures may be timed to match cash receipts or cash availability.

Cash flow management refers to the need to have cash come in -- flow in -- at the right times, so that it is available to flow out as needed. Everyone knows that if an organization has more expenses than income, sooner or later it will find itself in trouble. However, even if income matches or exceeds expenses in a given year, the cash from the income may not arrive in time to pay the bills as they come due. A cash shortage can be very disruptive to your ability to carry out your mission. To avoid disruptions of business or to take advantage of temporary cash surpluses, cash flow can and should be projected, monitored, and controlled.

5.2. PROJECTING CASH FLOW

Projections of receipts and expenditures, which comprise cash flow, are typically developed as part of the budget process, so that you can anticipate and develop strategies for funding the shortages or investing the surpluses. Cash flow projections follow a format similar to that of the budget. For each month, anticipate how much money you will receive and how much you will spend in each category.

To try this for the first time, you must look at your organization's prior year's checkbook as a basis for your cash flow projection for the coming year, adjusting for any anticipated changes that will affect the timing and amount of payments and deposits. These changes might include when your programs are offered, what programs are offered, new funding sources or expiration of previous funding, increases or reductions in interest rates, etc. While your new cash flow projection will largely correspond to your budget, some cash flow may come in from receivable from the prior year, cash may go out for payments made for last year's bills, and some income and expenses for the current year will be delayed until next year and, therefore, would not be included in the current year's cash flow budget.

As the year progresses, cash flow projections can be updated. By comparing budgeted cash flows to actual deposits and expenditures, and understanding the nature of any variances, one can strengthen your ability to accurately anticipate cash flow in the future.

In a simple example, imagine an organization with no cash in the bank and a balanced budget, with Rs. 100,000 in revenue and Rs. 100,000 in expenses. If the income is received first, the organization will be able to spend it down as expenses are incurred. If, however, the expenses come in before the income, the organization cannot pay its bills until the cash is received. In this case, the organization has a problem with the timing of cash flow rather than a shortage of revenue or an excess in expenses. Similarly in a number of grants, they are received as reimbursement i.e. the organization has to first arrange for the funds and then seek the reimbursement grant. This is not easy if the NPO does not have access to cash from its own operations.

There are common strategies for dealing with the timing of cash flows, whether it is a cash shortage or a cash surplus.

5.3. MEETING A PROJECTED TEMPORARY CASH SHORTAGE:

In such a situation the following options are available:

(i) Seek permission from the concerned funding agency to use their funds on another project on a temporary basis.
(ii) Liquidate investments e.g. fixed deposits and mutual funds
(iii) Obtain a temporary loan
(iv) Increase fundraising activities e.g. organize an event or fair.
(v) Dispose of old items and assets which are of no use.
(vi) Obtain a line of credit e.g. overdraft from the bank.
(vii) Delay of defer payments temporarily till cash comes in.
(viii) Obtain better credit terms

5.4. SURPLUS FUNDS:

This would require a different strategy and comply with the Income tax law. Such surplus funds could be invested in the following manner:

(i) Place the money in bank fixed deposits at such maturities as required to meet cash outflows
(ii) Place money at higher rates of bank interest to increase revenue for the organization.
(iii) Place money in mutual funds or other avenues where the money can be placed for three to five years and thereby earn revenue for the organization.
(iv) Invest in immoveable assets, which can be disposed of at a suitable profit.
(v) Start an income generating activity, which could bring in additional funds, however such an investment should out of the reserve of the organization.
(vi) Maintain a suitable bank and fixed deposit balance to meet sudden or unforseen expenses or a spurt in expenditure.

5.5. REASONS FOR CASH FLOW SHORTAGES:

Cash flow shortage arises on account of a vatirty of reasons such as:

(i) Expenses fall due before income is received

(ii) Seasonal receipts e.g. agricultural activities where money received only when the produce is sold and expenses have to be met continuously. Educational institutions, where fees are collected on a half yearly or quarterly basis.

(iii) Government Grants; Most often government grants are received towards the end of the year or in the subsequent year but expenses have tobe incurred on a regular basis.

(iv) Nature of Activities: The organization works in relief and rehabilitation sector and there is a major calamity e.g. tsunami or floods or earthquake, then the fund requirement soar virtually overnight.

(v) Running activities on old equipment e.g. old car, old computers etc. They suddenly get spoilt and there is a need for finance either for repair or to purchase a new asset.

(vi) Unexpected instances e.g. fire in the office or a the bank premises, or the bank fails. In this case funds are required for renovation and in the case of the bank fire then access to funds can be delayed or its failure then there is a possibility of loss of funds in addition to a substantial delay in accessing the money.

5.6. STRUCTURE OF CASH FLOW STATEMENT:

The most common structure is to reflect the opening balance; receipts from operations; receipts from agencies; receipts from investment activities; receipts from financing activities and the closing balance at hand.

Cash Flow from Operations:

This reflects funds received and expended from / on day to day operations, e.g. in a hospital daily fees received from patients and expenses on medicines, doctors and nursing staff salaries would form part of operation receipts and expenses. Receipts from funding agencies against approved projects would also be reflected here and corresponding expenditure on programme expenditure would be part operational expenses. Payments to suppliers, rent, taxes etc. also form part of operational expenses;

Cash Flow from Investing Activities:

Investing activities include capital expenditures – disbursements that are not charged to expense but rather are capitalized as assets on the balance sheet. Investing activities also include investments (other than cash equivalents as indicated below) that are not part of your normal line of business. These cash flows could include:

- Purchases of property, equipment, vehicle etc.
- Proceeds from the sale of property, equipment etc.
- Placing funds in long term investments or mutual funds
- Proceeds from the redemption of investments and mutual funds
- Interest earned on long term investments

Cash Flow from Financing Activities:

Financing activities include cash flows relating to the NGOs debt or capital financing. These will include the following:

- Proceeds from overdraft and loans
- Installment payments on loans or other repayment of debts
- Cash received towards the Corpus Fund
- Funds from donor-restricted gifts (e.g., restricted to buy equipment or establish a permanent endowment) of a long-term nature e.g. building fund, education fund, scholarship fund etc.
- Interest earned on restricted funds if being added to the said funds.

5.7. METHODS FOR PREPARING THE CASH FLOW STATEMENT

There are two methods for preparing the cash flow statement. Both the methods yield the same result but different methods are followed. The methods are :

(i) Direct method and
(ii) Indirect method.

Direct Method

Under the direct method the cash and bank accounts are analyzed to identify cash flows during the period. Herein a worksheet is prepared for each major line item and the effects of accrual basis accounting are eliminated to arrive at the net cash effect for that particular line item for the period. Some examples for the operating activities section include:

(i) Cash receipts from beneficiaries / customers:

Net sales per the income statement
Plus opening balance in accounts receivable
Minus closing balance in accounts receivable
Equals cash receipts from customers

(ii) Cash payments for Stock (e.g. medicines etc.)

Closing stock
Minus opening stock
Plus opening balance in accounts payable to suppliers
Minus closing balance in accounts payable to suppliers
Equals cash payments for stocks

(iii) Cash paid to employees:

Salaries and wages as per the account / projection
Plus opening balance in salaries and wages payable
Minus closing balance in salaries and wages payable

Equals cash paid to employees

(iv) Cash paid for operating expenses:

Operating expenses as per the ledger / projection
Minus depreciation expenses
Plus increase or minus decrease in prepaid expenses
Plus decrease or minus increase in accrued expenses
Equals cash paid for operating expenses

(v) Taxes paid:

Tax e.g. property tax, TDS etc. as per ledger account / projection
Plus opening balance in taxes payable
Minus closing balance in taxes payable
Equals taxes paid

(vi) Interest paid:

Interest expense as per the ledger / projection
Plus opening balance in interest payable
Minus closing balance in interest payable
Equals interest paid

Under the direct method, the cash flow statement would report the following in the cash flows from operating activities section of the cash flow statement:

Cash receipts from customers
Cash payments for inventory
Cash paid to employees
Cash paid for operating expenses
Taxes paid
Interest paid
Equals net cash provided by (used in) operating activities

Similar types of calculations can be made of the balance sheet accounts to eliminate the effects of accrual accounting and determine the cash flows to be reported in the investing activities and financing activities sections of the cash flow statement.

Indirect Method

In preparing the cash flows from operating activities section under the indirect method:

(i) the net income as per the income statement / projection is taken, then

(ii) reverse out entries to income and expense accounts that do not involve a cash movement, and show the change in net working capital. Entries that affect net income but do not represent cash flows could include income earned but not yet received, amortization of prepaid expenses, accrued expenses, and depreciation or amortization. Under this method the income and expense accounts and working capital is analyzed.

The following is an example of how the indirect method would be presented on the cash flow statement:

(i) Net income per the income statement

(ii) Minus entries to income accounts that do not represent cash flows

(iii) Plus entries to expense accounts that do not represent cash flows

(iv) Equals cash flows before movements in working capital

(v) Plus or minus the change in working capital, as follows:

(a) An increase in current assets (excluding cash and cash equivalents) would be shown as a negative figure because cash was spent or converted into other current assets, thereby reducing the cash balance.

(b) A decrease in current assets would be shown as a positive figure, because other current assets were converted into cash.

(c) An increase in current liabilities (excluding short-term debt which would be reported in the financing activities section) would be shown as a positive figure since more liabilities mean that less cash was spent.

(d) A decrease in current liabilities would be shown as a negative figure, because cash was spent in order to reduce liabilities.

The net effect of the above would then be reported as cash provided by (used in) operating activities.

The cash flows from investing activities and financing activities would be presented the same way as under the direct method

The above statement prepared for an annual presentation can then be broken down to half yearly and quarterly statements to further analyze and assess the fund requirement. Accordingly the cash budget will facilitate effective management of liquid resources while ensuring that programmes can be implemented keeping in mind any restriction on access to funds or to plan investments where there are surplus funds.

5.8. SUMMARY

- Introduction
- Projecting Cash Flows
- Methods of preparing Cash Flow Statements – Direct & Indirect Methods

Self Assessment Exercises

1. **What do you understand by Cash Flow?**
2. **Explain in detail the methods of projecting cash flows**