# UNIT 2 CONSTRUCTION AND ANALYSIS OF FUND FLOW AND CASH FLOW STATEMENTS

**Structure** **Page Nos.**



## 2.0 INTRODUCTION

Depending on the user's purpose, the term 'funds' may be used differently. Literally, it means a supply that can be drawn upon. In this sense it is used to mean cash, total current assets or working capital. We use it here in the sense of networking capital meaning **total current assets less current liabilities**.

Funds flow is used to refer to changes in or movement of current assets and current liabilities. This movement is of vital importance in understanding and managing the operations of a business.

We have seen in the unit dealing with balance sheet that every material transaction changes the position statement (or Balance Sheet). This, in other words implies a dynamic situation involving continuous movement of resources into the business, within the business and out of the business. The complexity of these flows increases with the increasing size and volume of business. Directly or indirectly, all these flows take place in business through the medium of **funds** and the same could be studied through the fund flow statement.

Funds in the form of cash and cash equivalents, in the right quantity are necessary for the smooth functioning of any business. The continuous movement of cash within the business and out of the business could be understood by studying the cash flow statement.

## 2.1 OBJECTIVES

After going through this unit, you should be able to:

- understand the idea of funds flowing through a business in a dynamic situation appreciate the role of working capital in the operations of a business;

- understand the sources and uses of working capital as well as cash during an accounting period from the financial statements;
- understand and interpret changes in working capital and cash identifying the causes of these changes; and
- use the funds flow statement and the cash flow statement as analytical tools.

## 2.2 STATEMENTS OF CHANGES IN FINANCIAL POSITIONS (SCFP)

Preparation of funds statement, excludes all those inter-firm activities of the enterprise, which do not affect its net working capital. Consequently, many of its significant activities like exchange of one or more current item (non current asset or non-current liability) with any other non-current item remains altogether unreported. No trace can be found from the funds flow statement even for the partial or total acquisition of non-current items of an enterprise in consideration of shares or/and debentures of any magnitude. To incorporate all these 'inter-firm non-current exchange transactions', which may substantially influence future funds, an all-pervasive flow statement, termed statement of changes in financial position is constructed.

**The Institute of Chartered Accountants of India's** (ICAI's) Accounting Standards – 3 (AS3) defines SCFD as : A "Statement of changes in financial position" summarising, for the period covered by it, the changes in the financial position including the sources from which funds were obtained by the enterprise and the specific uses to which such funds were applied.

According to **E.S.Hendrisen:** *one of the basic objections to the working capital concept of funds is that inter-firm transactions do not directly affect working capital and as such they are omitted from the funds flow statements. Thus, it does not provide correct or compete financial structure of the firm. A suggestive solution of the above stated problem is an all resources concept of funds, which would permit the inclusion of such transactions as the acquisition of property in exchange of stock or bonds, the receipt of property as a gift, and the exchange of non-current assets for other non-current items.* (Accounting theory, 19877 Ed.p.250).

Similar to funds flow statement, SCFP is also prepared from financial data like income statement, balance sheet, etc., and related notes. There is no specific format prescribed for the preparation SCFP. Where SCFP is supposed to be most informative, in those circumstances, it should be:

1) presented for each period for which the final accounts are prepared;
2) included as an integral part of the financial statements;
3) specific about where funds are provided from or used in the operations of an enterprise; and they should be presented separately from other sources or uses of funds other than those of operations.

Thus, SCFP, is designed to report all the causes of changes in financial position of an entity during the period that result from its financing and investing activities with others. Besides explaining the inflows and outflows of funds, it also reveals non-current external exchange transactions, which do not directly affect working capital. It thus, improves the understanding of the operations and activities of an enterprise for the related period.

## 2.3 ANALYSING CHANGES IN WORKING CAPITAL

In understanding the financial statements of a company, one of the first steps involved is the study of the changes in the financial position of the company and the reasons for the changes. We make an attempt at studying these changes and their causes by using the data contained in ~~the summ~~arised comparative balance sheets (Illustration 6.2) and profit and loss account of Tools India Limited (TIL).

**Illustration 6.2**

Tools India Limited
Balance Sheet as on December 31, 2004

**(Rs. in Million)**

| **Assets** | **December 31, 2004** | | **December 31, 2003** | |
|---|---|---|---|---|
| | **Rs.** | **Rs.** | **Rs.** | **Rs.** |
| **Current Assets** | | | | |
| Cash | 19.05 | | 10.87 | |
| Accounts Receivable (Sundry debtors) | 32.25 | | 20.28 | |
| Loans and Advances | 42.58 | | 33.82 | |
| Other Current Assets | 17.20 | | 15.93 | |
| Inventory | 120.92 | | 99.10 | |
| Total Current Assets | | 232.00 | | 180.00 |
| **Fixed Assets** | | | | |
| Plant and Equipment at Cost | 152.00 | | 133.00 | |
| Less: Depreciation | 71.00 | 81.00 | 60.00 | 73.00 |
| Furniture & Fixture at Cost | 14.50 | | 8.60 | |
| Less: Depreciation | 2.00 | 12.50 | 2.30 | 6.30 |
| **Investments** | | 2.00 | | |
| **Intangible Assets** | | | | |
| Technical Assistance Fees | 3.00 | | 1.00 | |
| Less: Amortisation | 0.50 | 2.50 | 0.30 | 0.70 |
| Total | | 330.00 | | 260.00 |
| **Liabilities and Capital** | | | | |
| **Current Liabilities** | | | | |
| Acceptance | 4.74 | | 3.02 | |
| Sundry Creditors (Accounts Payable) | 27.16 | | 18.75 | |
| Advances against Sales | 26.60 | | 20.28 | |
| Other Liabilities | 8.86 | | 7.95 | |
| Interest Accrued but not Due on Loans | 2.64 | | 2.00 | |
| | | 70.00 | | 52.00 |
| **Provisions** | | | | |
| For Taxation | 25.55 | | 20.45 | |
| Proposed Dividend | 2.25 | | 2.25 | |
| For Bonus | 3.40 | | 2.35 | |
| Other Provision | 3.80 | | 2.95 | |
| | | 35.00 | | 28.00 |
| Total Current Liabilities & Provisions | | 105.00 | | 80.00 |
| **Long Term Liabilities** | | | | |

| | | | | |
|---|---|---|---|---|
| Bank Loans | 40.00 | | 32.14 | |
| 10.5% Debentures | 25.50 | | 25.50 | |
| Loans from Financial Institutions | 24.50 | | 22.36 | |
| | | 90.00 | | 80.00 |
| Total Liabilities | | 195.00 | | 160.00 |
| **Capital** | | | | |
| Authorised : 5,00,000 shares of Rs.100 each | 50.00 | | 50.00 | |
| Issued, Subscribed and Paid-up | | | | |
| 3,73,100 Shares of Rs. 100 each | | 37.31 | | 37.31 |
| Reserves and Surplus | | 97.69 | | 62.69 |
| Total | | 330.00 | | 260.00 |

As we have studied at the beginning of this unit, the net change in working capital can be computed easily by subtracting the net working capital at the end of the year from the net working capital at the beginning of the year.

**TOOLS INDIA LTD**
**Change in Working Capital**

**(Rs. in Million)**

| | **December 31, 2002** | **December 31, 2003** |
|---|---|---|
| Current assets | 180.00 | 232.00 |
| Less: Current Liabilities | 80.00 | 105.00 |
| Working Capital | 100.00 | 127.00 |

| | |
|---|---|
| Working capital on December 31, 2004 | 127.00 |
| Working Capital on December 31, 2003 | 100.00 |
| Increase in Working Capital | 27.00 |

The Rs. 27 million increase in working capital of TIL shows the composite changes in the Current assets and current liability. This does not tell us much in terms of the operations of the business. This change could be the net result of changes in all the accounts covered by current items. There might have been qualitative changes resulting from the depletion of liquid items of current assets and increase in non-liquid items such as inventory. In order to answer these questions we try to analyse the changes in each of the working capital accounts.

**Statement of Changes in Working Capital**

A statement of changes in working capital helps us in locating where these changes took place. In the first instance we try to show the increase (decrease) in individual items and then try to classify them in terms of increase and decrease in working capital. Since working capital is measured by subtracting current liabilities from current assets, any **increase** in current assets and any **decrease** in current liabilities shows an **increase** in working capital. Similarly, a **decrease** in current assets and an **increase** in current liabilities represents a **decrease** in working capital.
The statement of changes in working capital (Table 6.1) shows that the increases in current assets amounted to Rs. 52 million, a major part of the increase arising out of cash, receivable and inventory. Decrease in working capital came about mostly from

the increased accounts payable, advances from customers and taxes payable. Total amount of decrease in working capital resulting from increase in current liabilities amounted to Rs. 25 million, thus, showing a net increase in working capital of Rs. 27 million.

**Table 6.1**

**TOOLS INDIA LTD.**

**Statement of changes in Working Capital for the year ending December 31, 2003**

**(Rs. in Million)**

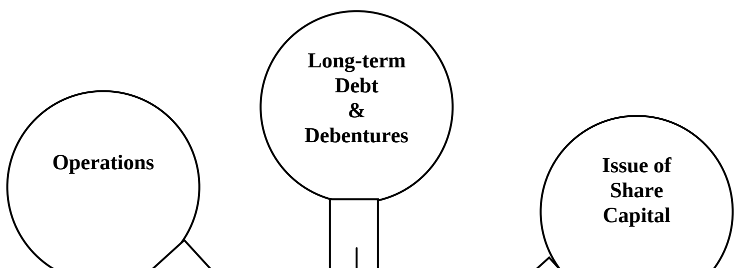
| | **Dec. 31 2004** | **Dec. 31 2003** | **Increase / Decrease** | **Working Capital** | |
|---|---|---|---|---|---|
| | | | | **Increase** | **Decrease** |
| **Current Assets** | | | | | |
| Cash | 19.05 | 10.87 | 8.18 | 8.18 | |
| Accounts Receivable | 32.25 | 20.28 | 11.97 | 11.97 | |
| Loans and Advances | 42.58 | 33.82 | 8.76 | 8.76 | |
| Other Current Assets | 17.20 | 15.93 | 1.27 | 1.27 | |
| Inventory | 120.92 | 99.10 | 21.82 | 21.82 | |
| Total | 232.00 | 180.00 | 52.00 | | |
| **Current Liabilities & Provisions** | | | | | |
| Acceptances | 4.74 | 3.02 | (1.72) | | 1.72 |
| Accounts Payable | 27.16 | 18.75 | (8.41) | | 8.41 |
| Advances against Sales | 26.60 | 20.28 | (6.32) | | 6.32 |
| Other Liabilities | 8.86 | 7.95 | (0.91) | | 0.91 |
| Interest Accrued | 2.64 | 2.00 | (0.64) | | 0.64 |
| Taxes Payable | 25.55 | 20.45 | (5.10) | | 5.10 |
| Proposed Dividend | 2.25 | 2.25 | – | | – |
| Bonus Payable | 3.40 | 2.35 | (1.05) | | 1.05 |
| Other Provisions | 3.80 | 2.95 | (0.85) | | 0.85 |
| Total | 105.00 | 80.00 | (25.00) | 52.00 | 25.00 |
| Working Capital | 127.00 | 100.00 | | 27.00 | |
| Increase in Working Capital | 27.00 | | | | |

## 2.4 FUND FLOW STATEMENT

An analysis of the fluctuations of current assets and current liabilities i.e. working capital tells us how the working capital has increased or decreased. Now, we want to know where the increased working capital is applied if it has increased, and from where funds have been transferred if it has decreased. The profit and loss account gives some indication of the results of operations and its impact on the funds position. We try to integrate the impact of operations reported in the profit and loss account and balance sheet by preparing a statement of changes in the financial position. It describes the sources from which funds were received and the uses to which funds were put. This statement of changes in financial position is usually referred to as **fund flow statement** or statement of sources and application of funds.

As the title indicates fund flow statement traces the flows of funds through the organisation. In other words, it shows the sources from where the funds were raised and the uses to which they were put.

**Inflows**



The statement of funds flow is usually bifurcated into two logical divisions: **sources of funds** or inflows during the periods and **uses of funds** or applications of funds or outflows of funds during the period. The division showing sources of funds summarises all those transactions, which had the net effect of increasing working capital. Uses of funds on the other hand deal with all those transactions, which had the effect of decreasing the working capital. We shall illustrate the primary structure of flows in *Figure 6.1*

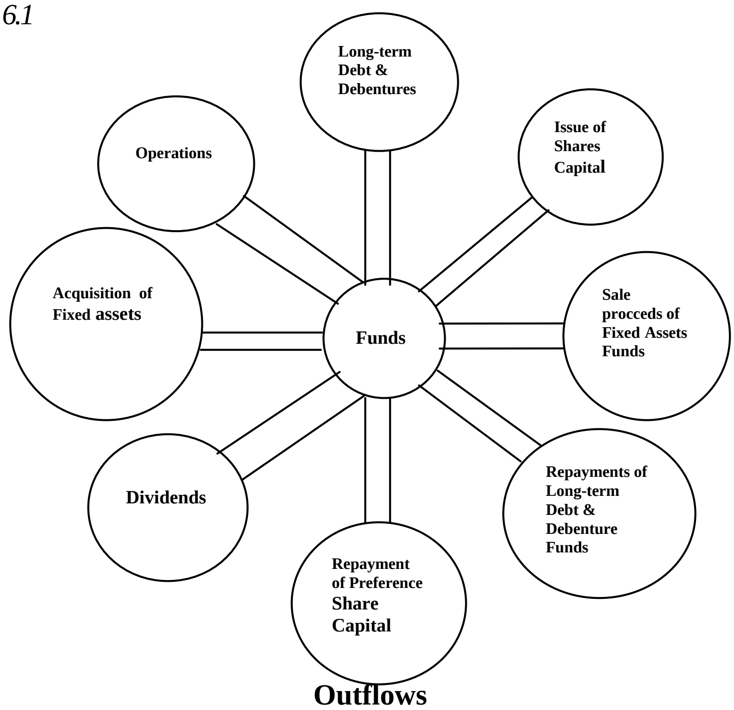



**Figure 6.1: Basic Flow of Funds**

The **flow of funds** statement gives a summary of the impacts of various managerial decisions. As such it reflects the policies of financing, investment, acquisition and retirement of fixed assets, distribution of profits, and the success of operations.

### ☞ Check Your Progress 1

1) Please list the four main sources of funds in an organisation.

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2) List the four main uses of funds in an organisation.

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## 2.5 SOURCES OF FUNDS

We have seen that working capital is required to finance that portion of current assets which is not financed by current liabilities. We also saw that the investments represented by current assets are converted into cash during the operating cycle. This implies that our need for financing is for one such cycle. Under normal circumstances every unit of investment in working capital is converted into cash at the end of the cycle at an added value, to the extent of profits.

When we are looking at the possible sources of working capital the most important source is this ‘internal generation’. The very idea of internal sources implies that there is something ‘external’.

**Internal Sources**

When we are looking for sources funds it is but natural to start searching at home. What do we have? While examining the need for working capital we could also make an assessment as to whether the existing working capital is sufficient or not. Thus, the first internal source is any excess working capital that we might be having.

If we have any non-current assets which do not have any use they could be disposed off, thereby generating additional working capital. Please note that this is not a regular and continuing source of funds.

We have seen earlier that every profitable sale brings with it funds in excess of what was expended on the goods sold. In other words, profits generated by the business contribute towards additional working capital. But you may also notice that whenever we measure profits, we match the revenue against all expenses relating to the revenue, whether it involves use of funds in the current period or not. Thus, the profits measured do not reflect the actual amount of funds available. In order to assess the actual funds generated from current operations we should add, back, to the profits all those items of expenses not involving use of funds during the current period. One major example of such an item is depreciation.

Thus, we could summarise the important possible inter sources of funds as:

1) Funds generated from operations. That is, profit plus depreciation and other amortisations; and some other adjustments;
2) sale of non-current assets;
3) any surplus working capital.

**Funds From Operations**

Refer to Illustration 6.1. The profit and loss account of TIL shows that operations have provided a gross addition of Rs. 360 million to funds during the period. These funds represent the sale proceeds of goods and services by the company and other incomes.

We also know that some part of these funds is utilised for meeting the cost of input such as material, personnel and other operating costs. Apart from these we also to meet the interest commitments and costs expiration of the machinery and equipment. However, expiration of the costs of the machinery and equipment (Depreciation) is one item which does not require use of funds in the current period.

**Illustration 6.1**

TOOLS INDIA LTD.
Summarised Profit and Loss Account
For the year ended December 31, 2004

**(Rs. in Million)**

| | | Rs. |
|---|---|---|
| Sales | | 350 |
| Other Income* | | 10 |
| | | 360 |
| Costs of Goods Sold | | 150 |
| Gross Profit | | 210 |
| Operating Expenses: | | |
| Personal | 60.00 | |
| Depreciation and Amortisation | 11.90 | |
| Other Expenses | 13.10 | 85 |
| Operating Profit | | 125 |
| Less: Interest Expense | | 15 |
| Net Profit before Income Taxes | | 110 |
| Less: Provision for Taxes | | 55 |
| Net Profit | | 55 |
| Less: Dividends | | 20 |
| Net Profit Retained | | Rs. 35 |

* Other income includes Rs. 1 million profit on sale of furniture.

Thus, funds provided from operations are in fact the revenues earned from operations (as also non-operating incomes) less all immediate costs of goods sold requiring use of funds. In other words, it is net income or profit after taxes plus all the non-fund expenses, such as depreciation and amortisation and adjusted for non-operating incomes and expenses.

The following statement would show funds from operations of TIL as follows:

**(Rs. in Million)**

| | |
|---|---|
| Operations | |
| Net Profit | 55 |
| Add: Depreciation and Amortisation (non-fund) | 11.90 |

| | |
|---|---|
| | 66.90 |
| Less: Profit on the Sale of Furniture (non-operating) | 1.00 |
| Total funds provided from operations | 65.90 |

**External Sources**

External sources of funds are resources raised from outside the organisation to augment funds availability for any of the uses to be discussed later. Normally, there are only two ways of doing this:

1) by contributing or raising additional capital, and
2) by increased long-term borrowing.

Please note that short-term creditors are not included as a source of funds since we have already defined funds as "current assets less current liabilities". Thus, working capital represents long-term investment in current assets and hence short-term borrowing will not increase working capital.

The sources of funds, as usually presented in the fund flow statement, are enumerated below:

**Sources of Funds**

| | | |
|---|---|---|
| Operations: | | |
| Net Profit after taxes | ______ | |
| Add: Depreciation | ______ | |
| Other amortisations | ______ | |
| Funds Provided by Operations | | ______ |
| New Issue of Share Capital | | ______ |
| New Issue of Debentures/Bonds | | ______ |
| Additional long-term Borrowing | | ______ |
| Sale Proceeds of Fixed Assets | | ______ |
| Sale of long-term Investments | | ______ |

☞ **Check Your Progress 2**

1) Please put down what 'internal' and 'external' sources are:

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## 2.6 USES (APPLICATIONS) OF FUNDS

**Need for Additional Funds**

A business would require Additional funds for two purposes:

1) Financing additional fixed assets, and
2) Financing additional working capital.

It should not be difficult to appreciate the necessity for having adequate fixed facilities with which to conduct business. The amount we have invested in the shop, furniture and fixtures has created the facilities for carrying on the business. It also determines the capacity to produce and to provide services. We cannot expand our business beyond a certain capacity which is limited by the facilities created by fixed assets. In case of a manufacturing firm, it will be plant capacity; in case of a transport undertaking it may be tonnage of trucks, ships or wagons; in case of show business and airlines it may be seating capacity, and so on. Any increase in such capacity would require additional investment. Thus, investment in fixed assets is required to expand capacity or to improve current operation. Usually, additions to investments are judged on the basis of its ability to reduce the present costs or to increase present output.

Additional working capital is required to finance increased holding of inventory, increased credit to customers and increased cash holding requirements. Obviously, current creditors would finance part of this requirement for working capital.

If a firm invests in another shop or in expansion of the existing shop, they will require additional funds for investment in fixed assets and also for increased level of current assets. You will notice that whenever additional investment is to be made in non-current assets, we have to use the funds (working capital) available with us unless separate arrangement is made for their financing. Likewise, when non-current assets are sold they provide funds or result in sources of funds.

We could summarise the usual applications of funds as follows:

1) Acquisition of new non-current assets (fixed assets)
2) Replacement of non-current debt (loans)
3) Payment of dividends
4) Increase in the balance of working capital (current assets–current liabilities).

If the trading or business operations are unsuccessful, they may use funds rather than provide funds. The uses of funds, as they are usually presented in the fund flow statement, are enumerated below:

**USES OF FUNDS**

| | |
|---|---|
| Dividends | …………….. |
| Redemption of Redeemable Preference Share Capital | …………….. |
| Repayment of Debentures/Bonds | …………….. |
| Repayment of Long-Term Loans | …………….. |
| Purchase of Fixed Assets | …………….. |
| Purchase of Long-Term-Investment | …………….. |
| Increase in Working Capital | |

### ☞ Check Your Progress 3

1) Please put down the list of application of funds.

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## 2.7 PREPARATION OF FUND FLOW STATEMENT

Let us further extend illustration 6.2 in order to prepare a Fund Flow Statement. From a comparative balance sheet and profit and loss account we could obtain most of the information we require for the preparation of a fund flow statement. We have studied that changes in the net-working capital amount are caused by the changes in non-working capital items. This may be seen from the summarised balance sheet of TIL *(Table 6.2).*

We have seen that the net working capital amount increased by Rs. 27 million during 2004, January 1 to December 31. This is other words implies that the working capital from **non-current sources** should exceed **non-current uses** by Rs. 27 million.

The summarised balance sheet shows the net change in each account. That is, it does not show the increases and decreases separately. Furniture and fixtures value, for example, has increased by a net amount of Rs. 5.90 million. This increase shows an application of funds. In reality, this account was both a source and an application of funds. We purchased new furniture and fixtures worth Rs. 7.90 million (a use of funds) and sold existing furniture and fixtures which had an original cost of Rs. 2 million and on which depreciation had accumulated to the tune of Rs. 1 million (a source of funds). Since the purchase transaction was bigger in amount than the sale transaction, the net result was in the 'use of funds'.

Table 6.2
TOOLS INDIA LTD.
Summarised Balance Sheet

**(Rs. in Millions)**

| | December 31, 2004 | December 31, 2003 | Change in Working Capital: Source | Change in Working Capital: Use |
|---|---|---|---|---|
| **Working Capital** | 127.00 | 100.00 | | 27.00 |
| **Fixed Assets** | | | | |
| Plant and Equipment at Cost | 152.00 | 133.00 | | 19.00 |
| Furniture and Fxtures at Cost | 14.50 | 8.60 | | 5.90 |
| **Investments** | 2.00 | | | 2.00 |
| **Intangible Assets** | | | | |
| Technical Assistance Fees at Cost | 3.00 | 1.00 | | 2.00 |
| | 298.50 | 242.60 | | |
| **Long-term Liabilities** | | | | |
| Bank Loans | 40.00 | 32.14 | 7.86 | |
| 10.5% Debentures | 25.50 | 25.50 | | |
| Loans from Financial Institutions | 24.50 | 22.36 | 2.14 | |
| **Allowance and Amortisations** | | | | |
| Accumulated Depreciation | | | | |
| Plant and Equipment | 71.00 | 60.00 | 11.00 | |
| Furniture and Fixtures | 2.00 | 2.30 | | 0.30 |
| Amortisation of Technical Assistance Fees | 0.50 | 0.30 | 0.20 | |
| **Capital** | | | | |
| Share Capital | 37.31 | 37.31 | | |
| Reserves & Surplus | 97.69 | 62.69 | 35.00 | |
| | 298.50 | 242.60 | 56.20 | 56.20 |

**Notes:** 1) Furniture and fixtures costing Rs. 2 million with an accumulated depreciation of Rs. 1 million is sold for cash at Rs. 2 million.

2) Dividend paid during the year amounted to Rs. 2.25 million.

If we are to construct a statement showing sources and uses of funds during the year, we need additional information. Some of this additional information is available from the profit and loss account and the appropriation of net income. Some other information like sales proceeds of assets will have to be obtained from the other records of the company.

**Funds Flow statement**

| | | **(Rs. in Million)** |
|---|---|---|
| **Sources of Funds** | | |
| Funds from Operations: | | |
| Net Income* | 37.25 | |
| Less Profit on Sale of Furniture | 1.00 | |
| | 36.25 | |
| Add: Depreciation, Amortisation, Provisions: | | |
| Plant | 11.00 | |
| Furniture | .70 | |
| Technical Assistance Fee | .20 | |
| | | 48.15 |
| Other Sources of Fund | | |
| Sale of Assets | 2.00 | |
| Bank Loan | 7.86 | |
| Institutional Loan | 2.14 | 12.00 |
| | | 60.15 |
| **Uses of Funds** | | |
| Payment of Dividends | 2.25 | |
| Purchase of Plant | 19.00 | |
| Purchase of Furniture | 7.90 | |
| Investments | 2.00 | |
| Technical Assistance Fees | 2.00 | |
| Increase of Working Capital | 27.00 | 60.15 |

* Net income has been obtained by deducting the previous year's balance of Reserves and Surplus from the current year's balance i.e. 97.69 minus 62.69=35 million. To this, the proposed dividend for the current year of Rs. 2.25 million has been added (as it must have been taken into account while determining the net income to be transferred to Reserves and Surplus).

With the necessary background on Profit and Loss Account and Fund Flow Statement having been prepared, you can now watch the Video Programme **"Understanding Financial Statement-Part II"** at your study centre.

## 2.8 CASH FLOW STATEMENT

Cash is another form of fund although in a narrow sense, it refers to a supply that can be drawn upon, according, to the need. Here the term cash includes both cash and cash equivalents. Cash equivalents are highly liquid short-term investments which could be easily converted into cash without much delay.

It may however be appreciated that the obligations and liabilities of a business arising on a day-to-day basis are met through "Cash" or "Cheque". But, inreality it never happens. Further, we must also be able to distinguish between "Profit" and "Cash". One cannot pay the creditors, electricity bills, tax or even dividend with the "Net Profit". For such and many other purposes, a business needs either cash balance or credit limits with banks. Not to be able to meet the business comitments through cash as and when these arise can spell disaster for a business even if it has a strong working capital base and has earned a handsome profit.

So far we have seen that the balance sheet and profit and loss account provide information on the financial position and the results of operations in a financial period. The funds flow statement explained earlier traces the flow of funds through the organisation. But neither of these financial statements can provide information about the cash flows relating to operating, financing and investing activities.

To ensure that the right quantity of cash is available in accordance with the needs of a business it is necessary to make a “cash planning” by determining the amount of cash entering the business (cash inflow) and the cash leaving the business (cash outflow). The statement which explains the changes that take place in cash position between two periods is called the cash flow statement.

Cash flow statement is an important tool in the hands of the management for short term planning and coordinating of various operations and projecting the cash flows for the future. It presents a complete view on the movement of cash and identifies the sources from which cash can be acquired when needed. The comparison of the actual cash flow statement with the projected cash flow statement helps in understanding the trends of the movement of cash and also the reasons for the success or failure of cash planning.

Cash flow and fund flow statements are similar to each other in many respects. The main difference however, lies in the fact that the terms “fund” and “cash” import different meaning. The term “fund” in fund flow statement has a wide meaning and it means current assets – current liability. A fund flow statement examines the impact of changes in fund’s position during the period under review on the working capital of the concern (working capital refers to current assets - current liabilities). Cash in the cash flow statement refers only to cash and or balance with bank, i.e., a small part of the total fund, although very important. The cash flow statement starts with the opening cash balance, shows the sources from where additional cash was received and also the uses to which cash was put and ends up showing the closing balance as at the end of the year or period under review. Whereas, there are no opening and closing balances in Funds Flow statement. Increase in current assets or decrease in current liabilities increases the working capital, whereas the decrease in current assets or increase in current liabilities increases the cash flow.

## 2.9 SOURCES AND USES OF CASH

A cash flow statement is a financial report that describes the source of a company's cash and how it was spent over a specified period of time. Because of the varied accrual accounting methods companies may employ, it is possible for a company to show profits while not having enough cash to sustain operations. A cash flow statement neutralises the impact of the accused/accrual entries on the other financial statements. It also categorises the sources and uses of cash to provide the reader with an understanding of the amount of cash a company generates and uses in its operations, as opposed to the amount of cash provided by sources outside the company, such as borrowed funds or funds from stockholders. The cash flow statement also tells the reader how much money was spent for items that do not appear on the income statement, such as loan repayments, long-term asset purchases, and payment of cash dividends.

Cash flow statements classify cash receipts and payments according to where they stem from. These can be classified under three broad categories, i.e., **Operating Activities, Investing Activities** and **Financing Activities.** A brief discussion of each of these categories is given below:

**Operating Activities** include cash inflows associated with sales, rendering of services and the cash outflows associated with operating expenses including payments to suppliers of goods or services, payments towards wages, interest and taxes, etc. Increase or decrease in current assets, e.g., receivables, inventory as well as increase or decrease in current liabilities, e.g., accounts payable, wages payable, interest payable, taxes payable also reflect operating activities.

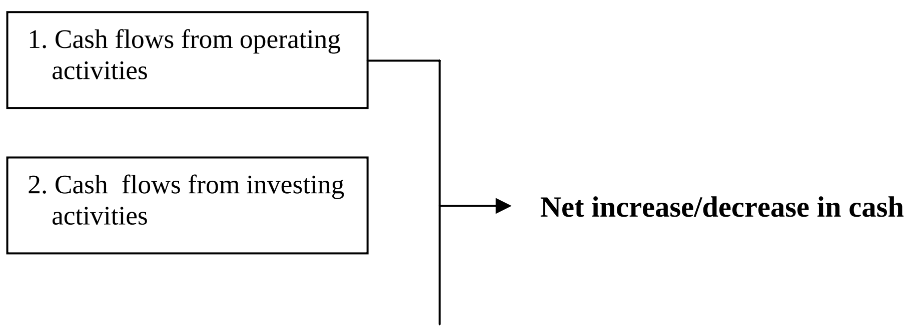
**Investing Activities** refer to acqisition and sale of fixed assets like land and building, plant and machinery etc. and buying and selling of investments. Acquisitions of these assets imply cash outflow whereas their disposal means inflow of cash.

**Financing Activities** encompass changes in equity and preference capital, debentures, long term loans and similar items. Issuance of equity, preference and debenture capital as well as raising of long term loans imply cash inflow. Retirement of capital, dividend payments to shareholders, redemption of debentures, amortisation of long term loans, on the other hand are associated with cash outflow.

The results from each section are added together to compute the net increase or decrease in cash flow for the firm. The format of the cash flows statement is given below:

| | | |
|---|---|---|
| *Cash Flows from Operations* | | |
| **Net Profit** | | **XXX** |
| *Add:* Any deducted non-cash item | | |
| Depreciation | XX | |
| Loss on disposal | XX | |
| Decrease in current assets | XX | |
| Increase in current liabilities | XX | XXX |
| *Less:* any added non-cash item | | |
| Gain on disposal | (XX) | |
| Increase in current assets | (XX) | |
| Decrease in current liabilities | (XX) | (XX) |
| **Net Cash flows from Operations** | | **XXX** |
| | | |
| *Cash Flows from Investment* | | |
| Proceeds from disposal of assets | | XXX |
| Dividend received | | XX |
| Purchase of assets | | (XX) |
| Net Cash flows from Investment | | XXX |
| | | |
| *Cash Flows from Financing* | | |
| Dividends paid | | (XX) |
| Issuance of stocks | | XXX |
| Increase in notes payables | | X |
| Increase in long term debt | | XX |
| Net Cash flows from Financing | | XXX |
| Increase in Cash and Marketable Securities | | XXX |
| Beginning Cash and Marketable securities | | XX |
| Ending Cash and Marketable securities | | XX |
| Change in Actual Cash Balance | | XXX |

**The summarised cash statement is:**



3. Cash flows from financing activities

## 2.10 PREPARATION OF CASH FLOW STATEMENT

To start with, we need two successive balance sheets and the operating statement or profit and loss account linking the two balance sheets.

There are two ways in which this statement can be drawn up. The first method is the direct method whereby major classes of gross cash receipts and gross cash payments are disclosed. The second method is known as the short-cut or indirect method. Under this method net profit or loss is taken as the basis and adjusted for the effects of transactions of non-cash nature, changes in current assets and current liabilities and transactions of income or expenses associated with financial cash flows.

**Direct Method**

Under the direct method, you are basically analysing your cash and bank accounts to identify cash flows during the period. You could use a detailed general ledger report showing all the entries to the cash and bank accounts, or you could use the cash receipts and disbursements journals. You would then determine the offsetting entry for each cash entry in order to determine where each cash movement should be reported on the cash flow statement.

Another way to determine cash flows under the direct method is to prepare a worksheet for each major line item, and eliminate the effects of accrual basis accounting in order to arrive at the net cash effect for that particular line item for the period. Some examples for the operating activities section include:

Cash Receipts from Customers:

- Net sales per the Income Statement
- Plus beginning Balance in Accounts Receivable
- Minus ending Balance in Accounts Receivable
- Equals Cash Receipts from Customers

Cash Payments for Inventory:

- Ending Inventory
- Minus Beginning Inventory
- Plus Beginning Balance in Accounts Payable to Vendors
- Minus Ending Balance in Accounts Payable to Vendors
- Equals Cash Payments for Inventory

Cash Paid to Employees:

- Salaries and Wages per the Income Statement
- Plus Beginning Balance in Salaries and Wages Payable
- Minus Ending Balance in salaries and Wages Payable
- Equals Cash Paid to Employees

Cash Paid for Operating Expenses:

- Operating Expenses per the Income Statement

- 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

Taxes paid:

- Tax Expense per the Income Statement
- Plus Beginning Balance in Taxes Payable
- Minus Ending Balance in Taxes Payable
- Equals Taxes Paid

Interest paid:

- Interest Expense per the Income Statement
- Plus Beginning Balance in Interest Payable
- Minus Ending Balance in Interest Payable
- Equals Interest Paid

Under the direct method, for this example, you would then report the following in the cash flows from the 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 the operating activities section under the indirect method, you start with net income per the income statement, 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 you have earned but not yet received, amortisation of prepaid expenses, accrued expenses, and depreciation or amortisation. Under this method you are basically analysing your income and expense accounts, and working capital. The following is an example of how the indirect method would be presented on the cash flow statement:

1) Net Income per the Income Statement
2) Minus Entries to Income Accounts that do not represent Cash Flows
3) Plus Entries to Expense Accounts that do not represent Cash Flows
4) Equals Cash Flows before movements in Working Capital
5) Plus or minus the change in Working Capital, as follows:

    - 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.

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

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

Preparation of a cash flow statement through Direct Method is a straight forward exercise and left to the students to follow up. Here, we would take up the cash flow statement by indirect method for further examination through an illustration appended below:

We use the above approach and procedure in preparing a "profit–basis" cash flow statement in Illustration 6.3.

**Illustration 2.3**

**The balance sheet of M/s. Gucci and Sammi Limited as at March 2003 and 2004 are given below:**

M/s Gucci and Sammi

| **Balance Sheets as at** | **31st March, 2003 Rs.** | **31st March, 2004 Rs.** |
|---|---|---|
| **Assets:** | | |
| Cash Balances | 50,000 | 60,000 |
| Plant and Machineries | 2,00,000 | 2,50,000 |
| Less: Accumulated Depreciation | 60,000 | 80,000 |
| Land | 1,00,000 | 80,000 |
| Inventory | 1,40,000 | 1,20,000 |
| Trade Debtors | 75,000 | 1,00,000 |
| | 5,05,000 | 5,30,000 |

| **Balance Sheets as at** | **31st March, 2003 Rs.** | **31st March, 2004 Rs.** |
|---|---|---|
| **Liabilities:** | | |
| Share Capital | 2,00,000 | 2,40,000 |
| Trade Creditors | 30,000 | 40,000 |
| Debtors | 1,50,000 | 90,000 |
| Retained Earnings | 1,25,000 | 1,60,000 |
| | 5,05,000 | 5,30,000 |

**Additional Information:** Cash dividends of Rs.25,000 has been paid during the year. You are required to prepare cash flow statement following the indirect method.

**Cash Flow Statement**

| | | **31st March, 2004** |
|---|---|---|
| | Rs. | Rs. |
| **Cash Flow From Operating Activities:** | | |
| Net Profit before Taxation* | 60,000 | |
| Add: Depreciation | 20,000 | |

| | | |
|---|---|---|
| Operating Profit before Working Capital Changes | 80,000 | |
| Net Increase in Debtors | (25,000) | |
| Net Decrease in Inventory | 20,000 | |
| Net Increase in Creditors | 10,000 | |
| Net Cash from Operating Activity (A) | | 85,000 |
| **Cash Flow From Investing Activities:** | | |
| Purchase of Plant and Machinery | (50,000) | |
| Proceeds from Sale of Land | 20,000 | |
| Net Cash Used in Investing Activities (B) | | (30,000) |
| **Cash Flow From Financing Activities:** | | |
| Issue of Share Capital | 40,000 | |
| Redemption of Debentures | (60,000) | |
| Dividends Paid | (25,000) | |
| Net Cash from Financing Activities (C) | | (45,000) |
| **Net increase in cash (A+B+C)** | | **10,000** |
| **Cash Balance at the Beginning of the Period** | | **50,000** |
| **Cash Balance at the End of the Period** | | **60,000** |

Note: *Profit for the period = Increase in retained earnings + Dividends paid
= 35,000 + 25,000
= 60,000

### ☞ Check Your Progress 4

1) Mention the four major operating activities included in a cash flow statement.

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## 2.11 SUMMARY

In this unit we have tried to develop the idea of flow of funds within the organisation. Starting with the funds requirement for an organisation, we have tired to trace the sources and uses of funds.
We tried to study the important sources of funds, namely, the operations, sale of fixed assets, long-term borrowings and issue of new capital. Similarly, important uses of funds were traced to acquisition of fixed assets, payment of dividends, repayment of loans and capital. The whole exercise reveals the areas in which funds are deployed and the sources from which they are obtained. Finally, we have learned how to go about doing the funds flow analysis with the help of published accounting information.

We learnt, distinguishing between cash and fund as also cash flow statement and funds flow statement. The importance of cash and cash flow statement was dwelt upon. Our discussion centered around cash flow statement on “cash basis” and “profit basis”. We learnt how to go about doing the cash flow analysis with the help of accounting information and finally presenting cash flows in the form of a “cash flow statement”.

## 2.12 KEY WORDS

**Cash Equivalents:** These are highly liquid short term investments which could be readily converted to cash and which are subject to an insignificant risk of changes in value.

**Cash Cycle** represents the time during which cash is tied up in operations.

**Funds from Operations:** The change in working capital resulting from operations. Difference between inflow of funds in the form of revenue and outflow of funds in the form of expenses.

**Sources of funds:** The sources from which we obtain working capital for application elsewhere. Sources include operations, extraordinary profits, sale of fixed assets, new long-term borrowings, new issue of capital and the reduction of existing working capital.

**Use of Funds:** Also referred to as application of funds means use of additional working capital and includes amounts lost in operations (Operating loss), acquisition of fixed assets, working capital used for retiring long-term loans, payment of dividends and amounts utilised to increase working capital.

**Working Capital:** Current assets minus current liabilities.

## 2.13 SELF-ASSESSMENT QUESTIONS/EXERCISES

1) What is working capital and what factors affect the size of working capital in an enterprise?

2) “Current assets to an extent are financed by current liabilities” Explain.

3) “Operations provide funds” Comment.

4) Differentiate between “Schedule of Changes in Working Capital” and “Fund Flow Statement.

5) Does a substantial balance in Retained Earnings indicate the presence of large cash balance?
6) “Net Profit of a business cannot pay dividend”. Comment.
7) Explain the purposes of a cash flow statement.
8) What are the differences between a cash flow statement and funds flow statement?
9) X Ltd. has a sales revenue of Rs. 1,000. Depreciation for the period is Rs.200. Other operating expenses are Rs.900. **Net loss** for the period is Rs.100.
   a) What is the amount of funds generated from operations during the period by X Ltd.?
   b) Under what circumstances can the funds from operation be zero?

10) The following information and the balance sheet relate to Shyamsons Ltd.:

SHYAM SONS LTD
Balance Sheet as on 31st December

| | Year 1 | Year 2 | Net change during the year Increase | Decrease |
|---|---|---|---|---|
| **Assets** | Rs. | Rs. | Rs. | Rs. |
| Cash | 10,000 | 15,000 | 5,000 | |
| Receivables | 20,000 | 25,000 | 5,000 | |
| Inventory | 20,000 | 35,000 | 15,000 | |
| Plant and Machinery Cost | 85,000 | 85,000 | | |
| Less: Accumulated Depreciation | (15,000) | (10,000) | | 5,000 |
| Total Assets | 1,20,000 | 1,50,000 | | |
| **Liabilities & Capital** | | | | |
| Sundry Creditors | 8,000 | 10,000 | 2,000 | |
| Outstanding Expenses | 7,000 | 10,000 | 3,000 | |
| Debentures Payable | 10,000 | 5,000 | | 5,000 |
| Long-term Loans | 5,000 | 25,000 | 20,000 | |
| Capital | 50,000 | 50,000 | | |
| Retained Earnings | 40,000 | 50,000 | 10,000 | |
| | 1,20,000 | 1,50,000 | | |

Net profit for the period after charging Rs.5,000 on account of depreciation was Rs. 20,000. A piece of equipment costing Rs.25,000 on which depreciation accumulated in the amount of Rs. 10,000 was sold for Rs. 10,000. Dividends paid during the year amounted to Rs. 10,000.

Prepare a Sources and Uses of funds statement in the following format:

SHYAMSONS LTD.
Sources and Uses of Funds

**(in Rs.)**

| **Uses of funds** | | **Sources of Funds** | |
|---|---|---|---|
| Purchase of Plant and Machinery | | Operations: | |
| | | Net Income | ——— |
| Repayment of Debentures | ——— | Add: Loss on Sale of Machinery | ——— |
| Payment of Dividends | ——— | | |
| Increase in Working Capital | ——— | Add: Depreciation | ——— |
| | | Sale of Equipment | ——— |
| | | Long-term Loan | ——— |
| Total uses of Funds | ——— | Total Sources of Funds. | ——— |

11) The Balance Sheet of Bestwood Limited as at 31st March 2003 and 31st March 2004 are as follows:

| | **31st March 2003** | **31st March 2004** | | **31st March 2003** | **31st March 2004** |
|---|---|---|---|---|---|
| | **Rs.** | **Rs.** | | **Rs.** | **Rs.** |
| Issued Share Capital | 60,000 | 80,000 | Freehold property at Cost | 50,000 | 50,000 |
| Profit and Loss Account | 54,000 | 46,000 | Equipment (see note) | 36,000 | 44,400 |
| Corporation Tax Due: | | | Stock in Trade | 32,800 | 35,600 |
| | | | Debtors | 27,200 | 28,000 |
| 31st March 2003 | 12,000 | – | Bank | 4,000 | 2,000 |
| 31st March 2004 | – | 8,000 | | | |

| | | | | | |
|---|---|---|---|---|---|
| Creditors | 24,000 | 26,000 | | | |
| | 1,50,000 | 1,60,000 | | 1,50,000 | 1,60,000 |

**Note:** Equipment movements during the year ended 31st March 2004 were:

| | **Cost Rs.** | **Depreciation Rs.** | **Net Rs.** |
|---|---|---|---|
| Balance at 31st March 2003 | 60,000 | 24,000 | 36,000 |
| Additions during the year | 18,000 | | |
| Depreciation provided during the year | | 7,600 | |
| | 78,000 | 31,600 | |
| Disposal during year | 8,000 | 6,000 | |
| Balance at 31st March 2004 | 70,000 | 25,600 | 44,400 |

The company's summarised profit calculation for the year ended 31st March 2004 revealed:

| | Rs | Rs |
|---|---|---|
| Sales | | 2,00,000 |
| Gain on Sale of Equipment | | 800 |
| | | 2,00,800 |
| Less: Cost of Goods and Trading Expenses | 1,73,200 | |
| Depreciation | 7,600 | |
| | | 180,800 |
| Net Profit | | 20,000 |
| Corporation Tax on Profits of the year | | 8,000 |
| Retained Profit of the year | | 12,000 |

During the year ended 31st March 2004 Bestwood Ltd. made a bonus issue of 1,000 ordinary shares of Rs. 10 each by capitalisation from the profit and loss account.

With the help of the above information , prepare a fund flow statement for Bestwood Ltd. revealing the sources and applications of funds during the year ended 31st March 2003.

**Answers to self-assessment Questions/Exercises**

1) Acquisition of new non-current assets (fixed assets)
2) Replacement of non-current debt (loans)
3) Payment of dividends
4) Increase in the balance of working capital (current assets–current liabilities)
10) (a) Funds generated from operations = Rs. 100
    (b) When operating cash expenses are equal to operating incomes or revenues.

11)

SHYAM SONS LTD.
Sources and Use of Funds

| **Use of Funds** | **Rs.** | **Sources of Funds** | **Rs.** | **Rs.** |
|---|---|---|---|---|
| Purchase of Plant and Machinery | 25,000 | Operations: Net Income | 20,000 | |
| Repayment of Debentures | 5,000 | Add: Loss on sale of Machinery | 5,000 | |
| Payment of Dividends | 10,000 | Add Depreciation | 5,000 | |

| | | | |
|---|---|---|---|
| Increase in Net Working Capital | 20,000 | | 30,000 |
| | | Sale of Equipment | 10,000 |
| | | Long-term Loan | 20,000 |
| Total uses of Funds | 60,000 | Total Sources of Funds | 60,000 |

**Working Capital Change**

| | Year 1 | Year 2 |
|---|---|---|
| Current Assets | 50,000 | 75,000 |
| Less: Current Liabilities | 15,000 | 20,000 |
| Working Capital | 35,000 | 55,000 |
| Increase in Working Capital | | 20,000 |

12) Decrease in working Capital Rs. 400
Funds from Sale of equipment Rs. 2,800.

## 2.14 FURTHER READINGS

1 *Understanding Financial Statements* Fraser Lyn. M and Aileen Ormiston, 04/10/2003, Prentice Hall: New Delhi (Chapter 4).

2. *Financial Management* , Pandey, I.M., 1999, Vikas Publishing House : New Delhi, Horngren, Charles T., Sundem Gary, L., 1994 (9th Ed.).

3. *Introduction to Management Accounting*, Prentice-Hall: Englewood-Cliffs of India Pvt. Ltd., New Delhi. (Chapter 14).

4 *Basic Accounting Practices*, Glantier, M. W. E., Underdown B. and A.C. Clark, 1979, Arnold Heineman: New Delhi: (Chapter 6, Section 6).

5 *Management Accounting*, Hingorani, N.L. and A.R. Ramanathan, 1986, Sultan Chand: New Delhi. (Chapter 8).