1. Details of Module and its structure

Module Detail	
Subject Name	Accountancy
Course Name	Accountancy 04 (Class XII, Semester – 2)
Module Name/Title	Cash Flow Analysis – Part 1
Module Id	leac_20601
Pre-requisites	Basic knowledge of General Accountancy & Cash Account
Objectives	After going through this lesson, the learners will be able to understand: • Cash Flow Introduction, Meaning, Objectives, etc • Various Type of Activities- Operating, Investing & Financing.
Keywords	Inflow and outflow of Cash, Cash and cash equivalents, Operating, Investing & Financing Activities

2. Development Team

Role	Name	Affiliation
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Table of Content:

1. INTRODUCTION TO CASH FLOW

As we all know, financial statements include Position Statement (showing financial position of an enterprise as on a particular date) & Income Statement (showing results of operational activities of an enterprise over a particular period). **The third very important content of financial statement is known as Cash flow statement**, which shows inflows and outflows of the Cash and Cash Equivalents.

This is a well-known fact that CASH plays a very important role in all the fields of a business. It is also important for a Business Organization to generate sufficient cash for its **survival**. A Company must pay great attention to liquidity if they are to succeed. **Negative cash flow** is a very strong sign of **potential problem** that can affect financing and investing activities. So, a systematic study of movement of cash in the business is very essential. So, For the purpose of understanding and analysing those transactions which affect cash flow, "Cash Flow Statement" is prepared.

Cash Flow Statement shows a company's inflows and outflows of cash during a particular accounting period. It shows the impact of Operating, Investing and Financing Activities on cash. Therefore, cash flow statement is **useful for proper financial planning and control**.

Moreover, Financial Statement of Companies are prepared by following the Accounting Standards issued by ICAI and prescribed in the Companies Act, 2013 (Revised). Accounting Standards are mandatory in nature (Section 133 of the Companies Act, 2013). If Accounting standards are not followed, financial statements will not be true and fair. Cash Flow Statement prepared in accordance with Accounting Standard- 3 (AS-3) - Cash Flow Statement.

2. MEANING OF CASH FLOW (INFLOW/OUTFLOW) AND CASH FLOW STATEMENT

Cash Flow Statement shows the inflow and outflow of cash and cash equivalents of the business during an accounting period.

Inflows of Cash means all those transactions that lead to an increase in cash and cash equivalents. Like, Cash Sales, Cash Received against Trade Receivables, Sale of Fixed Assets, Issue of Shares or Debentures, Cash Received for Interest, Commission, etc.

Outflows of Cash means all those transactions that lead to a decrease in cash and cash equivalents. Like, Cash Purchases, Cash Paid against Trade Payables, Expenses, Cash Purchase of Fixed Assets, Redemption of Preference Shares or Debentures, etc.

An important point to note is that Cash Flow includes Cash management. It means investment of excess cash & cash equivalents. But purchase of marketable securities or short-term investment is not considered while preparing cash flow statement as both are integral parts of Cash & cash equivalents

3. MEANING OF CASH AND CASH EQUIVALENTS

Cash & Cash Equivalents includes the following:

a) Balance with banks
b) Cheques, drafts on hand
c) Cash in hand
d) Others (like short – Term Marketable Securities)
e) Current Investments
f) Short – term Deposits in Banks

In other words- Cash, Near about Cash, or Quickly convertible in Cash.

4. OBJECTIVES OF CASH FLOW STATEMENT

Let us now understand, for what purpose we are making this Cash Flow

(i) To provide information about the **Cash inflows and outflows from various activities** (Operating, Investing and Financing Activities) during an accounting period.

(ii) To determine the **net change in Cash and Cash Equivalents**, i.e. to indicate the difference between the dates of two Balance Sheets.

5. IMPORTANCE OR USES OF CASH FLOW STATEMENT

(i) Helps in Short-Term Financial Planning:

As Cash Flow Statement gives information about Receipts and Payments of Cash and Cash Equivalents for a specific period, It helps in planning the short – term financial needs of the firm.

(ii) Helps in efficient Cash Management:

Cash Flow Statement informs the management about the Surplus or Deficit in cash which helps the Management in planning for Effective use of Surplus cash or Making necessary arrangements in case of Cash Shortage.

(iii) To assess deviation of cash and cash equivalents from related net earnings

It is not possible always that in a business concern the Actual cash and cash equivalents are equal to the Net earnings i.e **Net Profit is not equal to Cash**. Cash Flow Statement helps the management to assess the exact causes of difference between Actual Cash or Cash Equivalent and Net earnings **Either By eliminating Non-cash items of Income & Expenses OR**

It may be possible that a Business may have earned large profit But actual cash equivalents are low from its net earnings. It may be due to variety of reasons like Credit sales or due to Poor debt collection period during the year, Repayment of long-term loans, Purchase of assets etc.

Reverse case is also true i.e. a Business may have suffered heavy losses in accounting period, still it may have huge balance in Cash chest or Bank due to Issue of share capital, raising funds through Long term loans, Debentures, or may be Sale of fixed assets etc.

So, Cash Flow Statement will explain the reasons for the difference and along with that helps in reconciling the differences between the two**. (Profits vs. Cash)**

(iv) Helps in Comparative Study:

A comparison of the Actual Cash flows with the Cash Budget (Forecasted) will help the Business in determining as to how the financial resources of the Business have been Generated and Utilised as compared to the Plans.

(v) Helps in determining Cash Flows from different activities separately:

Cash Flow Statement divides the activities in three parts: Operating, Investing and Financing activities. We are able to determine cash generated by each Activity of the business (Separately).

(vi) Helps in assessing Liquidity and Solvency:

A cash flow statement helps in evaluating liquidity and solvency of the business. It facilitate different users of Financial Statements such as Investors, Creditors, Lenders, Financial Institutions and Management etc. to assess the ability of the business concern to meet its obligations well in time.

(vii) Helps in testing the Effectiveness of Managerial Decisions:

General rule is that Fixed Assets should be purchased from Long – term sources and long – term debts and their Charges (Interest) should also be repaid out of Cash generated from Operating activities. Cash flow statement shows whether this policy has been properly followed by the management or not.

(viii) Helps in making Dividend Decisions:

Dividend declared in General Meeting of Shareholders has to be paid in CASH within a month. And Dividend payable has also to be deposited in a separate bank account. As the Dividend has to be paid in CASH, Management has to take the help of Cash flow statement to determine the amount to be paid as dividend.

6. LIMITATIONS OF CASH FLOW STATEMENT

(i) It Ignores Non – cash Transactions:

Cash flow statement ignores many important transactions like Conversion of Debentures into Shares, Purchase of Fixed Assets on credit, etc. which do not involve inflows and outflows of cash. As a result, the true position of an enterprise cannot be judged by Cash – flow statement.

(ii) Totally Ignores the Accrual concept:

Cash Flow Statement ignores the most important concept of accounting, i.e., Accrual concept, as it deals only in CASH.

(iii) Historical in Nature:

Cash flow statement is prepared on the basis of information provided which is historical in nature, on the Balance Sheets of past two years. So, It would be more useful if it is accompanied by Projected Cash Flow Statement.

(iv) Not a Substitute for an Income Statement:

An Income Statement is based on Accrual System, it takes into account both cash and non – cash items. It shows net income of the firm. Cash flow represents only net cash inflow or outflow of cash. So, it cannot be taken as a substitute for an income statement.

(v) Not suitable for Judging Liquidity of the enterprise:

Liquidity does not depend upon Cash alone. Liquidity also depends upon those Assets (Investment in Gold, Land, etc.) which can be converted into Cash easily. As Cash Flow Statement exclude such Fixed Assets existing already OR maybe acquired through Non-Cash transactions, so it does not depict the true picture of liquidity of a firm.

(vi) Misleading Results if Based on Wrong Data

It uses the data of financial statements i.e., Statement of Profit & Loss and Balance Sheet. If there is any error in the data of financial statement, it will also reflect as an error in the Cash Flow Statement also. As the phrase goes, GIGO (Garbage in Garbage Out)

(vii) Mere Duplicity of Work

The primary data is contained in Statement of Profit and Loss and Balance Sheet. It is sort of rearranged in the Cash Flow Statement, (used as secondary data) which only consumes the time.

7. CLASSIFICATION OF ACTIVITIES FOR THE PREPARATION OF CASH FLOW STATEMENT

According to the Accounting Standard – 3 (Revised), Cash Flow Statement is to be prepared showing cash movement under the following three different heads, namely:

- **A. Cash Flow from Operating Activities;**
- **B. Cash Flow from Investing Activities; and**
- **C. Cash Flow from Financing Activities.**

So, the main purpose of Cash Flow Statement is to provide useful information about cash flows (inflows and outflows) of an enterprise during a particular period under these various heads, i.e. Operating, Investing and Financing activities. Cash Flow Statement helps in Planning and Effective Decision Making by identifying the Activity, in which business is having Surplus or Deficit [Cash and Cash equivalents] so that the management can take effective steps by arranging necessary funds in case of Deficiency or Invest Surplus funds in long term investments to earn higher rate of return, in case of Surplus funds available.

Let us first understand what these activities are.

Meaning and Explanation about Different Activities

A. Operating Activities: Main or Principal Revenue producing Activities.

Operating activities are the activities that constitute the primary or main activities of an enterprise. These are the Main or Principal Revenue generating activities of the enterprise. In other words, BREAD AND BUTTER ACTIVITIES. **Moreover, Sufficient Cash** from operations indicates the internal solvency level of the company, and a key indicator pointing towards the level or extent to which the operations of the enterprise have generated sufficient Cash flows **to maintain and sustain the operating capability of the enterprise, Paying dividends, Making of new investments and Repaying loans & Less dependence on the External sources of financing.**

Cash flows from operating activities which generally results from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are:

a. Receipts from the sale of goods and the rendering of services;
b. Receipts from royalties, fees, commissions and other revenue;
c. Payments to suppliers for goods and service;
d. Payments to employees;
e. Payments or refunds of income taxes

B. Investing Activities: Related to Acquisition / Disposal of Assets / Investments.

As per AS-3, Investing activities relate to Acquisition and Disposal of Long-term assets and Investments like Purchase and Sale of Machinery, Furniture, Land and building, etc. All the Transactions related to Long- Term Investment (Purchase / Sale) are also investing activities.

Cash flows from investing activities should be separately disclosed because they represent the **expenditures made for Resources intended to generate future income and cash flows**. Examples of cash flows from investing activities are:

a. Payments to acquire fixed assets;
b. Receipts from disposal of fixed assets;
c. Payments to acquire shares of the other enterprises;
d. Receipts from disposal of shares, warrants or debt instruments;
e. Loans made to third parties;
f. Receipt from the payment of advances and loans.
g. Interest, dividend and Rent received

C. Financing Activities: Change in Owner Capital & Borrowings of Enterprise.

Financing activities relate to Long-term funds or capital of an enterprise, e.g., Proceeds from issue of equity shares, Debentures, Long-term bank Loans, Repayment of bank loan, Redemption of Debentures / Preference Shares, etc. As per AS-3, financing activities results in changes in the size and composition of the Owners' capital (including preference share capital in case of a company) and Borrowings of the enterprise. Separate disclosure of Cash flows from financing activities is important because it **helps in predicting claims on future cash flows by Providers of funds (both capital and borrowings) to the enterprise**. Examples of financing activities are:

a. Proceeds from issuing shares or other similar instruments;
b. Proceeds from issuing debentures, loans;
c. Repayments of amounts borrowed;
d. Payment of dividends;
e. Payment of interest.

Now, Let us do some Examples to understand Type of activities.

QUESTION 1. [CBSE PATTERN]

Classify the following transactions as Operating, Investing and Financing Activities for (i) Financial Enterprise, and (ii) Non – Financial Enterprise.

1. Interest paid on Debentures   2. Dividend received on Shares

3. Sale of Investments   4. Interest received on Investments

5. Dividend Paid
6. Loans and Advances made
7. Receipt of Loans and Advances made
8. Commission paid on purchase of securities
9. Sale of Securities
10. Purchase of Securities

SOLUTION 1:

No. Transactions	Financial Enterprise	Non-Financial Enterprise
1. Interest paid on Debentures	Operating	Financing
2. Dividend received on Shares	Operating	Investing
3. Sale of Investments	Operating	Investing
4. Interest received on Investments	Operating	Investing
5. **Dividend paid**	**Financing*** **	**Financing*** **
6. Loans and Advances made	Operating	Investing
7. Receipt of Loans and Advances made	Operating	Investing
8. Comm. paid on purchase of securities	Operating	Investing
9. Sale of Securities	Operating	Investing
10. Purchase of Securities	Operating	Investing

QUESTION 2. [CBSE PATTERN]

Classify the following transactions into

(a) Operating Activities, (b) Investing Activities and (c) Financing Activities

(i) Commission received

(ii) Issue / Redemption of Debentures

(iii) Increase / Decrease in Bank Overdraft

(iv) Increase / Decrease in Cash Credit

(v) Purchase / Sale of goodwill

(vi) Interest paid on 12% Debentures by non-financial enterprise

(vii) Purchase / Sale of machinery

(viii) Interim Dividend paid on Equity Shares

(ix) Interest received on Investment.

SOLUTION 2:

	Transactions	**Activity**
(i)	Trading Commission received	Operating
(ii)	Issue /Redemption of Debenture	Financing
(iii)	Increase / Decrease in Bank Overdraft	Financing
(iv)	Increase / Decrease in Cash Credit	Financing
(v)	Purchase / Sale of goodwill	Investing
(vi)	Interest paid on 12% Debentures by non-financial enterprise	Financing
(vii)	Purchase / sale of machinery	Investing
(viii)	Interim Dividend paid on equity shares	Financing
(ix)	Interest received on Investment	Investing

Let us now take an Example to understand Inflows, Outflows of CASH.

QUESTION 3. [CBSE PATTERN]

State which of the following would result in inflow /outflow of Cash and Cash Equivalents:

1. Conversion of Debentures into Shares by a company.
2. Declaration of dividend.
3. Sale of Marketable Securities at profit.
4. Interest paid on Long term loan.
5. Depositing Cash into Bank.
6. Purchased machinery Rs. 1,00,000. Paid by Cheque.
7. Paid to creditors Rs. 90,000.
8. Converted Rs. 50,000 equity shares into 12% debentures.
9. Received cash Rs. 80,000 from Trade Debtors.
10 Issued equity shares Rs. 5,00,000 for cash.
11 Building Purchased by issue of shares.
12 Furniture costing Rs. 5,000 sold for Rs. 10,000.
13 Depreciation on Plant & Machinery.
14 Issue of Bonus Shares.

SOLUTION 3:

No.	**Effect on Cash Flow**	**Reason and Explanation**
1.	No Flow	As Both items related to non – current items.
2.	No Flow	Declaration of Dividend mean that it has not been paid.
3.	Inflow	Movement between items of cash or cash equivalents, but more cash inflow, as at a profit.
4.	Outflow	Payment of cash to Lenders.
5.	No Flow	Movement between two items of cash or cash equivalents.
6.	Outflow	Cash and Cash Equivalents (Bank) decreased by Rs. 1,00,000.
7.	Outflow	Cash and Cash Equivalents decreased by Rs. 90,000.
8.	No Flow	As Both items are related to non – current items.
9.	Inflow	Cash and Cash Equivalents increased by Rs. 90,000.
10.	Inflow	Cash and Cash Equivalents increased by Rs. 5,00,000.
11.	No Flow	As Both items are related to non – current items.
12.	Inflow	Cash and Cash Equivalents increased by Rs. 10,000.
13.	No Flow	No involvement of Cash and Cash Equivalents. Non-Cash
14.	No Flow	No involvement of Cash and Cash Equivalents. Non-Cash