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 2
Module Id	leac_20602
Pre-requisites	Basic knowledge of General Accountancy & Cash Account
Objectives	After going through this lesson, the learners will be able to understand: • Steps to prepare Cash Flow Statement- Indirect Method • Treatment of Non-cash Items, Proposed Dividend • Effect of Working Capital Changes.
Keywords	Non – operating Income, Non – operating Expenses, Non- Cash Items.

2. Development Team

Role	Name	Affiliation
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1. HOW TO PREPARE CASH FLOW STATEMENT

We know that Cash flow statement provides information about change in the position of Cash and Cash Equivalents of an enterprise, over an accounting period. The activities which contribute to this change are **classified into Operating, Investing and Financing**.

So, while preparing a cash flow statement, full details of Inflows and Outflows are calculated under these heads. Then the aggregate of the "Net Cash flows" (+ / -) i.e INFLOWS or OUTFLOWS is worked out and shown as Net Increase/Decrease in Cash and Cash Equivalents during the period in which the amount of "Cash and cash equivalent at the beginning" is added and thus the amount of "Cash and cash equivalents at the end" is arrived at. This figure will be the same as the total amount of Cash in hand, Cash at bank and cash equivalents given in the Balance Sheet at the end.

Another point is that Cash flows from operating activities can be worked out by an indirect method or by direct method. However, unless specified clearly as to which method is to be used, the Cash flow statement is prepared by an indirect method.

While preparing Cash Flow Statement AS-3 (Revised) following steps are required:

Step no.1. Calculation of Cash Flows from Operating Activities.

Step no 2. Calculation of Cash Flows from Investing Activities.

Step no 3. Calculation of Cash Flows from Financing Activities.

Step no 4. Calculation of net increase / decrease in cash and cash equivalents during the Year, which is the Total of 1st three steps.

Step no 5. Now, Add Opening Balance in Step 4, to get Final Closing Balance (As Given in th Closing Balance Sheet)

Following records must be available for the preparation of Cash Flow Statement

(a) Balance Sheets for two successive years (including Notes to Accounts),

(b) Statement of Profit & Loss for the current period and

(c) Additional Information (Adjustments) relevant for preparation of Cash Flow Statement.

NOW, LET US BEGIN WITH

STEP NO. 1. CALCULATION OF CASH FLOWS FROM OPERATING ACTIVITIES

Operating Activities are the (Main) **principal revenue generating** activities of the business enterprise and different from other activities which are Investing and Financing Activities. Operating Activities includes Cash Flow from all the business transactions, **having a direct relation in ascertainment of net income of the business concern.**

For example, **Trader of Computer Merchant's** main activity will be purchasing and selling of Computers; **For a Bank / Financial Institution,** main activity will be giving and taking loans; Similarly **For an Insurance Company** main activity will be acceptance of premium and settlement of insurance claims are the MAIN REVENUE generating activities. So cash flows under ALL these categories will come under 'Cash Flows from Operating Activities'.

Cash flow from Operating Activities can also be computed with the combination of the following:

1. Statement Profit & Loss of the current year,
2. Comparative Balance Sheets and
3. Relevant additional information.

As per AS-3 (Revised), following activities are regarded as Cash flow from operating activities:

For Non-Financial Companies

1. Receipts from sale of goods or rendering services;
2. Receipts from royalties, fees, commissions and other revenue;
3. Receipts from Trade Receivables (Debtors and Bills Receivables)
4. Payment for purchase of goods and services
5. Payment to Trade Payables (Creditors and Bills Payables).
6. Payment of Salaries, Wages etc. to employees;
7. Receipts/ Payments to insurance co. for premiums, claims, annuities or other policy benefits;
8. Payment as income tax or refunds of income tax unless, they relate to financing /investing
9. Receipts or Payments for forward / option contracts and swap contracts, (trading purposes).

For Financial Companies

1. Receipts from sale of securities (Investments)
2. Payment for purchase of securities (Investments)
3. Dividend received on securities (Investments)
4. Interest received on loan granted
5. Payment of interest on Loan & borrowings
6. Payment of salaries, wages etc. to employees

7. Payment of income tax or refunds of income tax unless they relate to financing or investing.

8. Receipts or payments for forward / option contracts and swap contracts (trading purposes).

As we know that Net income shown by the Statement of Profit & Loss can't be regarded as the Cash Flows from Operating Activities, because of the fact that the profit as shown by the Statement of Profit & Loss is the net result, after considering all elements whether they are cash items or non-cash items and

In other words, Profit & Loss Account is based on ACCRUAL CONCEPT (DUE BASIS).

AS-3 (Revised) has suggested **two methods** of computing net cash from operating activities:

1. **INDIRECT METHOD**
2. **DIRECT METHOD**

Format of Cash Flow Statements.

1. INDIRECT METHOD

A. Cash flow from operating activities:

Net Profit/Loss before Tax & Extraordinary Items**

Add: Non-Cash / Non – operating expenses (Already deducted in P/L Statement)

- Depreciation
- Loss on Sale of Assets / Interest TOTAL
- Preliminary Expenses / Goodwill / Disc. Etc. WRITTEN OFF.
- Interest Paid on Debentures / Loans
- Prem. on Red. Of Pref. shares/ Debentures

Less: Non- Cash / Non –operating Incomes (Already added in P/L Statement)

- Interest / Dividend / Rent Received
- Gain on sale Assets

Cash from operating Activities before working cap. Change and Extraord. Item &Taxes.

Working Cap. Changes

Dec. in Current Assets	(+)
Inc. in Current Assets	(-)
Inc. in Current Liabilities	(+)
Dec. in Current Liabilities	(-)

Cash from operating Activities before Extraordinary Items and Taxes

Add: Extraordinary Incomes (+)

(Damages /Compensation/ Claims)

Less: Extraordinary Losses (-)

Cash from op. Activities before Taxes

Less: Income Tax paid *(Net of Refund of Tax)

Cash from operating Activities (A)

B. Cash flow from investing activities:

- Purchase of fixed assets (-)
- Sale of fixed assets / Investments (+)
- Dividend / Intt. / Rent Received (+) NET (+ / -)

C. Cash flow from financing activities

- Issue of shares / debentures (+)
- Taking of Loans (+)
- Red. of Debentures / Preference Shares (-)
- Repayment of Loans (including prem.) (-)
- Interest / Dividend Paid (-) NET +/-

Cash and cash equivalents during the year (A+B+C)

Add. Opening Bal.(cash, Bank, Short Term Invest, Marketable Securities)

Closing Balance. (Cash, Bank, Short Term Inv, Marketable Securities) ANSWER.

1st Important Working Notes:

**Calculation of Net Profit before Tax and Extraordinary Items:

Surplus, i.e., Balance in Statement of Profit and Loss (Closing Balance)	
Less: Surplus, i.e., Balance in Statement of Profit and Loss (Opening Balance)	(....)
Profit for the Year (Difference)	.....
Add: Transfer to Reserve	.....
Add: Provision for Tax (Current Year)	.....
Add: **Proposed Dividend**** (**PREVIOUS YEAR- UNPAID STILL**)	.....
Net Profit before Tax and Extraordinary Items	.....

***NOTE:**

Sometimes, the amount of net profit is not given specified & the Statement of profit and loss is also not given. In such case, Net profit can be worked out by comparing the balances of Statement of Profit and Loss given in the comparative balance sheets for two years. The difference between two figures is treated as the Net profit for the year.

2. DIRECT METHOD (NOT IN SYLLABUS FOR 12TH CLASS)

Coming to two Brain Storming Points Now

1. CAN A SINGLE TRANSACTION INCLUDE TWO TYPE OF ACTIVITIES??

YES, a single transaction may include cash flows that can be classified in different activities. For example, when the **Instalment** is paid for a fixed asset acquired on Credit basis, it **includes both Interest and Loan. Interest Paid** be classified under **Financing** Activities and **Loan element** will be classified under **Investing Activities**.

2. CAN SAME TRANSACTION BE CLASSIFIED AS DIFFERENT ACTIVITY???

Yes, the same activity may be classified differently for different enterprises. It will depend upon the Nature of Business, the Company is engaged in. For example, **Purchase of shares** is an **Operating Activity** for an Investment Firm while it is an **Investing activity** in case of other enterprises. Similarly, **Interest Paid & Interest Received** are an **Operating Activity** for an Investment Firm while **Interest Received** is an **Investing activity** in case of other enterprises & **Interest Paid is a Financing Activity** in case of other enterprises.

NOW, LET US ELABORATE OUR DISCUSSION WITH SOME QUESTIONS LIKE:

WHY DO WE ADD BACK NON CASH AND NON-OPERATING EXPENSES OR DEDUCT NON CASH AND NON-OPERATING REVENUE???

Non-cash items are those items of Income or Expenses, which have appeared in the Expenditure side OR Revenue side of the Statement of Profit & Loss but they do not have any impact on CASH BALANCE. These items only affect the profit/loss as shown by Statement of Profit & Loss without causing any Inflow or Outflow of CASH in the business.

Non-operating items are those items of Income or Expenses, which have appeared in the Expenditure side OR Revenue side of the Statement of Profit & Loss but they do not have any impact on OPERATING CASH. Which means that CASH is affected, but they are not the DAILY / RECURRING / MAIN ACTIVITY of the Business.

So, in order to **convert the Accrual based** Statement of Profit & Loss **into Cash based** Income Statement, all these items must be adjusted (Added / Subtracted).

Now let us discuss some of these items in detail.

1. DEPRECIATION ON FIXED ASSETS

Depreciation is a revenue expense in the Statement of Profit & Loss which reduces the profit of the business concern but being a **non-cash expense**, this will **not reduce the cash balance** in any way. So, while computing Cash flows from operating activities, this item is added back to the figure of Net Profit.

2. AMORTIZATION OF INTANGIBLE ASSET GOODWILL, TRADE MARKS, ETC.

Amortization of intangible assets is also a revenue expense in the Statement of Profit & Loss which will reduce the profit of the business concern but again being a **non-cash expense**, this will **not reduce the cash balance** in any way. So, while computing cash flows from operating activities, this item is also to be added back to the net profit. Now, all these items are being added to get the REAL CASH PROFITS i.e Cash Flow from Operating Activities.

3. PROFIT OR LOSS ON SALE OF FIXED ASSETS

Profit on sale of fixed assets will **increases the net profit but it is** not to be included in cash from operating activities, as it is an activity **related to Investments of the company**.

Similar explanation hold good for Loss on sale of fixed assets which will decreases the net profit but again without decreasing the cash balance. Also it is an activity **related to Investments of the company.**

So both these points have to be adjusted. **Profit on sale of fixed assets should be deducted and Loss on sale of fixed assets should be added back respectively**, to the Net profit figure, so that cash flow from operating activities can be computed.

Similar explanation can be given for other items also.(In short)

PROVISION FOR INCOME-TAX: While making a Provision for Income-Tax also, there is no Cash Outflow, but being an expense, it reduces the Net Profits. So, it being a Non-cash expense, will be Added Back to the figure of Net Profits.

PREMIUM ON REDEMPTION OF DEBENTURES: Non-operating expense. As it related to the Financing Part of the Business and there is also a Cash outflow, but that will be dealt in FINANCING ACTIVITIES.

TRANSFER TO GENERAL RESERVE: Again a Non-operating / Non-cash item, Basically an Appropriation, after Profits are earned. Will be added only if Profits are considered as a difference between Two Balance Sheet Figures of Profits, i.e when we start the Question with the difference in figures of P/L OPENING & CLOSING BALANCE.

****VERY IMPORTANT POINT—PROPSED DIVIDEND/ DIVIDEND PAID. *****

Proposed Dividend of previous year will be ADDED BACK IN P&L as well as PAID AMOUNT IN FINANCING ACTIVITIES.(Paid= Proposed- Still payable i.e Unpaid). Dividend remains unpaid due to variety of reasons like death of Shareholder, Shareholder not residing at the address, Postage loss, etc.

PROPOSED DIVIDEND OF CURRENT YEAR will be shown as a **CONTINGENT LIABILITY** as it is yet to be finalized in Board meeting, to be held after 31/3/ of the relevant year. This change in position is as per Latest Revision of Accounting Standard by ICAI.

LET US NOW TALK ABOUT OTHER THINGS LIKE WORKING CAPITAL CHANGES, EXTRAORDINARY ITEMS AND TAX PAID ONE BY ONE.

WORKING CAPITAL CHANGES

Increase or decrease in Current Assets & Current Liabilities, come under this head. Rule is that Inflow of Cash to be Added & Outflow of Cash to be deducted.

Decrease in Current Assets indicates Inflow of cash and is added to determine net cash generated from operating activities. Let us understand this with the help of following example:

Suppose Inventory in the beginning and at the end of the year were Rs. 70,000 and Rs. 55,000. Such a decrease in inventory indicates that there is an inflow of cash due to sale of inventory. So, Rs. 15,000 will be added to the operating profit. Let us take another example to understand in yet another way with a different explanation.

If figures of Debtors have decreased during the year it means we must have received some amount from customer during the year. As this amount does not form part in the sales figures as shown by Income Statement. So, to arrive at the Actual cash received from customers this amount (equal to decrease in value of Debtors) must be added back to the Sales figure as shown by Income Statement INDIRECTLY by adding it in NET PROFITS.

CONCLUSION: All decrease in CURRENT ASSETS are to be ADDED

Increase in Current Liabilities also indicates Inflow of cash and is added to determine net cash generated from operating activities. For example:

Suppose Creditors in the beginning and at the end of the year were Rs. 80,000 and Rs. 90,000. Increase in Creditors indicates that they were paid Rs. 10,000 less than the amount of credit purchases during the year. Hence, increase in Creditors indicates that they are being paid less amount, OR indirectly we have taken a sort of cash, which increases the cash generated from operating activities.

CONCLUSION: All increase in CURRENT LIABILITIES are to be ADDED

Increase in Current Assets will indicates Outflow of cash and is subtracted to determine net cash generated from operating activities. To take an example:

Suppose Inventory in the beginning of the year were Rs. 50,000 and inventory at the end of the year were Rs. 60,000. This increase in inventory indicates outflow of cash due to more purchase of inventory in the year. So, Rs. 10,000 will be subtracted in the Cash Flow Statement. Let us take another example to understand in yet another way with a different explanation.

If Debtor have increased during the year, it means total sales made during the year must be including some credit sales which must have increased the profit with the same amount whereas this amount equal to the increase in values of debtors is not yet realized (As the Balance has increased). So, the increase in value of Debtors must be deducted from the figure of net sales to arrive at the figures of **Actual cash received from customers**.

CONCLUSION: All increase in CURRENT ASSETS are to be DEDUCTED.

Decrease in Current Liabilities indicates Outflow of cash and is subtracted to determine cash generated from operating activities. Let us understand by the following example:

Suppose Bill Payables in the beginning of the year and at the end were Rs. 30,000 Rs. 20,000. Decrease in Bill Payables indicates that they were paid Rs. 10,000 more than the amount due during the year which decreases the cash generated from operating activities.

CONCLUSION: All decrease in CURRENT LIABILITIES are to be DEDUCTED