

CASH FLOW STATEMENTS

Financial Statements form part of the financial reporting process. A complete set of financial statements normally includes a balance sheet, a profit and loss statement (or 'an income and expenditure statement' or 'income statement'), a cash flow statement and those schedules, notes, explanatory material and other statements that are an integral part of the financial statements. However, financial statements do not include such items as reports by directors, statements by the chairman, representation, discussion and analysis by the management and similar items that may be included in financial or annual reports. The Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) has issued a conceptual framework, "Framework for the Preparation and Presentation of Financial Statements", which deals with the matters relevant and relating to the financial statements and which is subject to revision from time to time on the basis of the experience of the ASB of working with it. In this paper, the matters relating to the cash flow statements, which normally forms a part of the financial statements of various enterprises to which the Accounting Standard (AS) 3, 'Cash Flow Statements', become mandatory, is discussed in the light of, and on the basis of, the said Accounting Standard.

The Accounting Standard:

The Council of the ICAI, after considering the benefits and importance of the cash flow information, and such other matters relating thereto, has issued the Accounting Standard (AS) 3, 'Cash Flow Statements', (revised 1997), (hereinafter 'the AS'), which came into effect in respect of accounting periods commencing on or after 01.04.1997, and which superseded the Accounting Standard (AS) 3, 'Changes in Financial Position', issued in June, 1981. The AS defines the terms, describes the benefits and importance and gives material in respect of cash flow statements. It deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating investing and financing activities.

Applicability of the AS:

1. The AS is mandatory in nature in respect of accounting periods commencing on or after 01.04.2004 for the enterprises which fall in any one or more of the following categories, at any time during the accounting period-

- a. Enterprises whose equity or debt securities are listed whether in India or outside India.
- b. Enterprises which are in the process of listing their equity or debt securities as evidenced by the Board of directors' resolution in this regard.
- c. Banks including co-operative banks.
- d. Financial institutions.
- e. Enterprises carrying on insurance business.
- f. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. ('Turnover' does not include 'other income').
- g. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.
- h. Holding and subsidiary enterprises of any one of the above said categories at any time during the accounting period.

2. The enterprises not falling within any of the above said categories are encouraged to apply the AS, even though it is not mandatory for them. (See http://icai.org/resource/C_list_state_audit_accou.html).

3. If an enterprise has been covered in any one or more of the above said categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from application of the AS. However, if the enterprise ceases to be covered in any of the above said categories for two consecutive years, then it will qualify for exemption from application of the AS.

4. If an enterprises which is not covered form the above said categories, but subsequently falls within any or more of the above said categories, in the current accounting period, then the AS becomes applicable from the current period. In such circumstances, the enterprise need not required to disclose the corresponding previous period fissures.

5. An enterprises which is required to prepare and present a cash flow statement, in accordance with the provisions aforesaid, should prepare and present it for each period for which financial statements are presented; if the enterprise does not prepares and presents so, then the fact thereof should be disclosed.

Benefits and Importance:

The users of an enterprise's financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise's activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise. Enterprises need cash to conduct their operations, to pay their obligations and to provide returns to their investors.

When cash flow statements are used in conjunction with the other financial statements, it provides such information which enables the users to evaluate the changes in net assets of an enterprise, its financial structure, its liquidity and solvency position and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. The ability of the enterprises to generate cash and cash equivalents can be assessed through studying the cash flow statements. It enables the users to develop models to assess and compare the present value of the future cash flows of different enterprises and enhances the comparability of the reporting of operating performance by different enterprises because in eliminates the effects of using different accounting treatments for the same transactions and events. Historical cash flow information is used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

Definitions:

The AS defines certain expressions which have been used in it. According to it, the expression-

- i. “cash” comprises cash on hand and demand deposits with banks:
- ii. “cash equivalents” are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.
- iii. “cash flows” are inflows and outflows of cash and cash equivalents.
- iv. “operating activities” are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
- v. “investing activities” are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
- vi. “financing activities” are activities that result in changes in the size and composition of the owners’ capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Presentation of Cash Flow Statement:

An enterprises, to which the AS applies should, or if it does not apply, then voluntarily may, present a cash flow statement which should report cash flows during the period classified under distinct heads of activities -operating, investing and financing activities- in a manner which is most appropriate to its business. Such classification under distinct heads of activities enables the users to assess the impact of those activities on the financial position of the enterprises and the amount of its cash and equivalents and to evaluate the relationships among those activities. A single transaction may include cash flows that are classified differently. For example, when the cash repayment of a loan includes both interest and capital, the interest element may be classified as an operating activity and the capital element is classified as a financing activity.

Cash and Cash Equivalents:

The AS defines the expressions “cash” and “cash equivalents”. Cash equivalents are held for the purpose of meeting short-term cash commitments by an enterprise. They are not intended, normally for investment or other purposes. An investment falls within the purview of meaning of cash equivalents, when it becomes readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Thus, the terms, liquidity position, convertibility into cash and risks, in relation to an investment is to be considered before treating it as a cash equivalent. Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents. The movements between items that constitute cash or cash equivalents forms part of the cash management process. These movements should not be treated as cash flows. An example for cash management is investing of excess cash in cash equivalents.

Components of Cash and Cash Equivalents:-

An enterprise should-

- i. disclose the components of cash and cash equivalents:
- ii. present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet:
- iii. disclose the policy adopted to determine the compositions of cash and cash equivalents.
- iv. disclose the fact of any change, and effect thereof, if any, in the policy (referred to in above point iii), in accordance with the Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Related Other Disclosures:

The amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by it should be disclosed, together with a commentary by management, for the benefit of the users. Such disclosure may include:

- i. the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and
- ii. the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity.

This information enables the users to determine whether the enterprise is investing adequately in the maintenance of its operating capacity, failure of which may prejudice future profitability for the sake of current liquidity and distributions to owners. An example of the circumstance, where the cash and cash equivalent balances held by an enterprise but not available for use by it, is holding them by a subsidiary that operates in a country where exchange controls or other legal restrictions apply when the balances are not available for general use by that enterprise.

Cash Flows from Operating Activities:-

The cash flows from principal revenue-producing activities of an enterprise is referred to as cash flows from operating activities. The transactions and events which determines net profit or loss causes for such cash flows. The information of cash flows from operating activities is a key indicator of the extent to which the operations of the enterprises have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without recourse to external financing sources. When used with relevant other information, information relating to the specific components of historical operating cash flows is useful in forecasting future operating cash flows.

The AS provides some examples of cash flows from operating activities. These are:

- i. cash receipts from the sale of goods and the rendering of services;
- ii. cash receipts from royalties, fees, commissions and other revenue;
- iii. cash payments to suppliers for goods and services;
- iv. cash payments to and on behalf of employees;

- v. cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- vi. cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
- vii. cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

The results of certain transactions may have direct impact on net profit or loss. Even though such impact, the cash flows arising from such transactions should be classified as appropriate. For example, gain or loss arising from the sale of a fixed asset is included in the determination of profit or loss. However, the cash flow in respect of that transaction should be classified as cash flow from investing activities. An enterprise may hold securities and loans for dealing and trading purposes. In such cases, such securities and loans are like inventory, which acquired specifically for resale, of the enterprise. The dealing or trading with such securities and loans constitutes main revenue-producing activity of the enterprise. Therefore, cash flows arising from the purchase and sale of dealing or trading securities should be classified as operating activities. And in the case of a financial enterprise, cash advances and loans made by it are usually classified as operating activities.

Methods of Reporting of Cash Flows from Operating Activities:-

There are two different methods - direct method and indirect method - using either of which the cash flows from operating activities can be reported through a cash flow statement. (See also under the head “Reporting Cash Flows on a Net Basis” below).

A. Direct Method:-

When direct method is used, to report cash flows from operating activities, the major classes of gross cash receipts and gross cash payments are disclosed. It provides information which enables the users to estimate future cash flows and which is not available under indirect method. Such position gives raise to consider the direct method more appropriate

than the indirect method. According to the AS, the information relating to major classes of gross cash receipts and gross cash payments, under the direct method may be obtained either:

- a. from the accounting records of the enterprise; or
- b. by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for:
 - i. changes during the period in inventories and operating receivables and payables;
 - ii. other non-cash items; and
 - iii. other items for which the cash effects are investing or financing cash flows.

B. Indirect Method:-

When indirect method is used, to report cash flows from operating activities, the net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments and items of income or expense associated with investing or financing cash flows. As per the AS, the net cash flow from operating activities, under the indirect method, is determined by adjusting net profit or loss for the effects of:

- a. changes during the period in inventories and operating receivables and payables;
- b. non-cash items such as depreciation, provisions, deferred taxes and unrealized foreign exchange gains and losses; and
- c. all other items for which the cash effects are investing or financing cash flows.

Alternatively, under the indirect method, the net cash flows from operating activities may be presented by showing the operating revenues and expenses excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Investing Activities:-

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

- i. cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;
- ii. cash receipts from disposal of fixed assets (including intangibles);
- iii. cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- iv. cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- v. cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
- vi. cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
- vii. cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
- viii. cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Financing Activities:-

The cash flows arising from financing activities, when disclosed separately, is useful in predicting claims of future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are:

- i. cash proceeds from issuing shares or other similar instruments;
- ii. cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and
- iii. cash repayments of amounts borrowed.

Reporting Cash Flows from Investing and Financing Activities:-

Subject to the paragraphs 22 and 24 of the AS, an enterprise should report major classes of gross cash receipts and gross cash payments arising from investing and financing activities, separately. Paragraphs 22 and 24, of the AS, provides that the cash flows, of special character, may be reported on a net basis.

Reporting Cash Flows on a Net Basis:-

The cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

- a. Cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise.

Examples of such cash receipts and payments are:

- i. The acceptance and repayment of demand deposits by a bank;
- ii. fund held for customers by an investment enterprise; and
- iii. rents collected on behalf of, and paid over to, the owners of properties.

- b. Cash receipts and payments for items in which the turnover is quick, the amounts are large, and maturities are short. Examples of such cash receipts and payments are:

advances made for, and the repayments of:

- i. principal amounts relating to credit card customers;
- ii. the purchase and sale of investments; and
- iii. other short-term borrowings, for examples, those which have a maturity period of three months or less.

In the case of a financial enterprise, cash flows arising from each of the following activities may be reported on a net basis:

- a. Cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date:
- b. The placement of deposits with and withdrawal of deposits from other financial enterprises: and
- c. Cash advances and loans made to customers and the repayment of those advances and loans.

Foreign Currency Cash Flows:

According to the AS, cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow. A rate that approximates the actual rate may be used if the result is substantially the same as would arise if the rates at the dates of the cash flows were used. The effect of changes in exchange rates on cash and cash equivalents held in a foreign currency should be reported as a separate part of the reconciliation of the changes in cash and cash equivalents during the period. Cash flows denominated in foreign currency are reported in a manner consistent with Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates. This permits the use of an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions. Unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end-of period exchange rates.

Extraordinary Items:-

The cash flows relating to the extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and should be disclosed separately in the cash flow statement. Such disclosed information may be useful to the users to analyse

their nature and effect on the present and future cash flows of the enterprise. The Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, requires the disclosure of the nature and amount of extraordinary items. However, the disclosure in the cash flow statement, as stated earlier, should be in addition to the disclosure required by the AS 5.

Interest and Dividends:

The cash flows arising from interest and dividends received and paid should each be disclosed separately and be classified according to the nature of enterprise. In the case of financial enterprises, interest paid and interest and dividends received should be classified as cash flows from operating activities. In the case of other enterprises (i.e. non-financial enterprises), the cash flows arising from interest and dividends paid should be classified as cash flows from financing activities and interest and dividend received as cash flows from investing activities.

The total amount of interest paid during the period may, according to its nature, and accounting policies and practices, be recognised as an expenses in the profit and loss statement or capitalised in accordance with the Accounting Standard (AS) 10, Accounting for Fixed Assets. However the total amount of interest paid during the period should be disclosed in the cash flow statement.

The AS, through paragraphs 32 and 33, states that interest paid and interest and dividends received are usually classified as operating cash flows for a financial enterprise. However, there is no consensus on the classification of these cash flows for other enterprises. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are cost of obtaining financial resources or returns on investments. Some argue that dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows. However, it is considered more appropriate that dividends paid should be classified as cash flows from financing activities because they are cost of obtaining financial resources.

Taxes on Income:

The cash flows arising from taxes on income should be separately disclosed. Unless tax cash flows can be specifically identified with financing and investing activities, they should be classified as cash flows from operating activities. The total amount of taxes paid should be disclosed where tax cash flow is allocated over more than one class of activity.

Investments in Subsidiaries, Associates and Joint Ventures:

The paragraph 36 of the AS reads thus when accounting for an investment in an associate or a subsidiary or a joint venture, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee or joint venture, for example, cash flows relating to dividends and advances.

Acquisitions and Disposals of Subsidiaries and Other Business Units

The aggregate cash flows, arising from acquisitions and from disposals of subsidiaries or other business units, during the period, should be classified as investing activities and the total purchase or disposal consideration and the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents is to be disclosed separately. Such presentation distinguishes those cash flows from other cash flows. The cash flow effects of disposals are not deducted from those of acquisitions.

Non-Cash Transactions:-

The non-cash transactions should not be included in a cash flow statement as these items do not involve cash flows in the current period. The non-cash transactions, many of which investing and financing activities, does not bear any direct impact on current cash flows even though they may affect the balance sheet item(s). Such transactions should be disclosed in the financial statements appropriately. Examples of non-cash transactions are:

- i. the acquisition of assets either by assuming directly related liabilities;
 - ii. the acquisition of an enterprise by means of an equity issue; and
 - iii. the conversion of debt to equity.
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