(Continued)

Cash Flow Statement

Cash flow statement shows, how cash was generated and how it was used during the period. These days, it is required by law to include this statement in financial statements, especially in case of financial statements of limited companies.

Need For Cash Flow Statement

For any business, it is important to ensure that:

- Sufficient profits are made to compensate owners for the investment made, efforts put in and the risk taken for the business,
- Sufficient funds are available to meet the obligations of the business as and when required.

The information as to profitability is provided by the Profit and Loss Account. The information as to availability of funds or financial health is provided by the balance sheet. But the balance sheet is prepared on a specific date and can provide information of financial position as on that date only. Cash flow, on the other hand provides more detailed information about the movement of funds during the period. With the help of cash flow, we can determine the amount of cash generated form different sources and the areas on which it is utilized.

Difference between Profitability and Liquidity

Liquidity

It is the ability of a business to pay its debts in time. By having good liquidity, we mean that a business has sufficient liquid funds (cash and cash equivalents) so that it can repay liabilities.

Cash

Cash includes cash in hand and demand deposits.

Cash Equivalents

Cash equivalents are those short term investments that can be converted into a known amount of cash at any time. Usually, investments up to three months maturity are included in cash equivalents.

People generally mix up profitability with liquidity. One might think that if a business has earned, say, One Million Rupees of profit than it should have approximately the same amount of cash in it.
But mostly this is not the case. Consider the following example:

- A person starts a small business with Rs. 10,000.
- He purchases goods worth Rs. 20,000. Rs. 10,000 is paid in cash and remaining is payable at the end of the month.
- The same day, all the goods are sold on credit of two months for Rs. 30,000.
- Now if we draw a profit and loss account at the end of the month, the business has earned a profit of Rs. 10,000, considering no expenses.

- But at the same time, it is time to pay to the Creditors, whereas payment from debtor is not due yet.
- This means that although the business earned a profit of Rs. 10,000 but it has no cash to pay to its creditors.
- This simple example helps us to understand that liquidity is different from profitability
- But it is as important as profitability.

Components of Cash Flow Statement

Cash flow statement is divided into three components

- Cash Flow from Operating Activities
- Cash Flow from Investing Activities
- Cash Flow from Financing Activities

Cash Flow From Operating Activities

Cash flow from operating activities is generally derived from the principal revenue producing activities of the business.

Cash Flow from Operating Activities is the indicator of success or failure of a business's operations. If the cash flow from operations is continuously negative, this means that the business revenue is not enough to recover the costs that are incurred to earn it. Therefore, in the long run Cash flow from operations must be positive.

Examples of cash flows from operating activities are:

- Cash receipt from sale of goods and rendering of services.
- Cash receipts from fees, commission and other revenues.
- Cash payments to suppliers for goods and services.
- Cash payments to and on behalf of the employees.
- Cash payments or refunds of income taxes.

EXAMPLE

Net Profit before Tax	**16,514**	
Add: Adjustment for Non-Cash Items		
Depreciation for the Year	5,500	
Provision for Doubtful Debts	810	
Exchange Gain / Loss	-	
Gain / Loss on Disposal of Assets	-	
Return on Investments	4,000	
Mark-up on Loans	3,500	
Operating Profit Before Working Capital Changes	**30,324**	
Working Capital Changes		
Add: Decrease in Current Assets		40,000
Less: Increase in Current Assets	(50,000)	
Add: Increase in Current Liabilities	-	
Less: Decrease in Current Liabilities	-	
Cash Generated From Operations	**20,324**	
Less: Markup paid on loans	(3,000)	

Less: Taxes Paid	(5,000)
Net Cash Flow from Operating Activities	**12,324**

Cash Flow From Investing Activities

Cash flow from investing activities includes cash receipts and payments that arise from Fixed and Long Term assets of the organization.

Cash Flows from Investing Activities shows the investment trend of the business. If it is negative (Outflow) this means that the company is investing in long term assets and is expanding. On the other hand if it is positive (Inflow) over the years, this means that the company is selling its long term investments.

Examples of cash flows from investing activities are:

- Cash payments to acquire property plant and equipment. These also include payments made for self-constructed assets.
- Cash receipts from sale of property plant and equipment.
- Cash payments and receipts from acquisition and disposal of other than long term assets e.g. Shares, debentures, TFC, long term loans given etc.

If assets are held for trading purposes or in normal course of business e.g. car / property dealers and loans given by banks, then cash flow from these are included in Operating Cash Flow.

EXAMPLE

Cash Flow from Investing Activities

Add: Disposal of Fixed Asset and Long Term Investments	100,000
Less: Acquisition of Fixed Assets and Long Term Investments	(80,000)
Add: Dividend Received / Returns on Investment Received	-
Net Cash Flow from Investing Activities	**20,000**

Cash Flow From Financing Activities

Cash flow from financing activities includes cash receipts and payments that arise from Owners of the business and other long term liabilities of the organization.

Cash Flows from Financing Activities shows the behavior of investors (both equity capital and debt capital). A positive figure (inflow) shows that funds are being invested in the company and vice versa.

Examples of cash flows from financing activities are:

- Cash received from owners i.e. share issue in case of company and capital invested by sole proprietor or partners.
- Cash payments to owners i.e. dividend, drawings etc.
- Cash receipts and payments for other long term loans and borrowings.

EXAMPLE

Cash Flow from Financing Activities

Add: Shares Issued / Capital Invested	1,000,000
Less: Dividend Paid / Drawings	(400,000)
Add: Increase in Long Term Borrowings	150,000
Net Cash Flow from Financing Activities	**750,000**

Procedure Of Preparing Cash Flow

Cash Flow Statement is prepared as follows:

- We start from the Profit / Loss for the period before taxation.
- Adjustments are made for non-cash items that are included in the profit and loss account such as Depreciation, Provisions and other items that relate to investing and financing activities.
- This gives us Operating Profit before Working Capital Changes.
- Then Working Capital Changes, i.e. increase or decrease in items of current assets and liabilities, are added / subtracted (Cash and Cash Equivalents are not included here)
- This gives the Cash Flow from Operations.
- To this figure, we add / subtract cash flows from investing and financing activities.
- This gives us Net Increase / Decrease in Cash and Cash Equivalents.
- To this figure we add Opening Balance of Cash and Cash Equivalents (that we excluded from current assets)
- This gives us the Closing Balance of Cash and Cash Equivalents.

Increase or Decrease is generally taken as difference in opening and closing balances of accounts reported in balance sheets.

FORM OF CASH FLOW STATEMENT

Name of the Entity
Cash Flow Statement for the Period Ending -----

Net Profit before Tax	**XYZ**	
Add: Adjustment for Non-Cash Items		
Depreciation for the Year	XYZ	
Provision for Doubtful Debts	XYZ	
Exchange Gain / Loss	XYZ	
Gain / Loss on Disposal of Assets	XYZ	
Return on Investments	XYZ	
Mark-up on Loans	XYZ	
Operating Profit Before Working Capital Changes	**XYZ**	
Working Capital Changes		
Add: Decrease in Current Assets		XYZ
Less: Increase in Current Assets	(XYZ)	
Add: Increase in Current Liabilities	XYZ	
Less: Decrease in Current Liabilities	(XYZ)	

Cash Generated From Operations	**XYZ**	
Less: Markup paid on loans	(XYZ)	
Less: Taxes Paid		(XYZ)
Net Cash Flow from Operating Activities	**XYZ**	
Cash Flow from Investing Activities		
Add: Disposal of Fixed Asset and Long Term Investments		XYZ
Less: Acquisition of Fixed Assets and Long Term Investments	(XYZ)	
Add: Dividend Received / Returns on Investment Received	XYZ	
Net Cash Flow from Investing Activities	**XYZ**	
Cash Flow from Financing Activities		
Add: Shares Issued / Capital Invested	XYZ	
Less: Dividend Paid / Drawings	(XYZ)	
Add: Increase in Long Term Borrowings	XYZ	
Net Cash Flow from Financing Activities	**XYZ**	
Net Increase / Decrease in Cash and Cash Equivalents	XYZ	
Add: Opening Balance of Cash and Cash Equivalents	XYZ	
Closing Balance of Cash and Cash Equivalents	**XYZ**	

IV) Statement of cash flows. This final Financial Statement provides net results of cash inflows (receipts) and cash outflows (payments) during an accounting period. Banks/creditors/investors look for this statement, because it gives them a picture of net cash flow of the business. As already explained, positive net income (profit) does not necessarily mean increase in cash. Therefore such statement must be prepared in order to depict actual cash position. It is clear that a highly profitable business may also go bankrupt. Therefore profitability does not necessarily mean solvency i.e. ability to pay debts and obligations. This fact gives rise to the need for preparing cash flow statement.

Parts of cash flow statement

Cash "flows" through a business during accounting period by Cash & Cash equivalent (T-bills, saving certificates, bonds etc), and through operating activities which include, producing or delivering goods for sale and providing services, and also cash effects of transactions and other events that determine net income.

For example Cash flows/collections from sales and interest and dividends received would be cash Inflows. Similarly, purchase of inventories and payment of operating expenses would constitute cash outflows.

Generating positive cash from operations is the preferred method to finance capital expenditure, debt repayments and dividend payments.

The third method or process by which cash "flows" through a business is the group of its activities called investing activities which include short-term investments, acquiring/disposing of securities, acquiring/disposing of plant assets, and lending money/collecting loan.

The fourth method or process of cash flow is the group of activities called "Financial" activities which include borrowings from creditors/repaying the principal, obtaining resources from owners, and providing owners with return on investment.

The fifth method or process of cash flow in a business is of course the effect of exchange rate fluctuations on cash.

To prepare cash flow statement, look at changes in all of balance sheet accounts from beginning to end of accounting period, and transfer the changes to appropriate area of cash flow statement.

Cash Flow from operating activities.

Inflows in this case are: - cash collections from customers, Interest/dividends collected, and other operating cash receipts e.g. proceeds from litigations.

Outflows would be, cash paid to suppliers & employees, interest & taxes paid and other operating cash payments e.g. payments in litigations.

It should be noted that receipt and payment of interest are classified as operating activities and not investing or financing activities.

Net of the “Inflows” and “Outflows”, gives cash flow from operating activities.

Cash flow from investing activities:

Inflows in this case are proceed from sales of Certificates/ Securities, proceeds from sales of Plant assets, and collection of loans (principal).

Outflows here would be purchase of Certificates/Securities, purchase of plant assets, and loans made to borrowers.

Net of ‘Inflows’ and ‘Outflows’ gives cash flow from investing activities.

Cash flow from financing activities

Here, the ‘Inflows’ are proceeds from borrowings, proceeds from issuing “bonds payable”, and proceeds from issuing capital stock.

Outflows correspondingly are payment to settle debts (principal), and payment of dividends.

Net of ‘Inflows’ and ‘Outflows’, gives cash provided by financing activities.

Sum of net cash flows from all the three activities viz Operating, Investing and Financing gives overall cash flow during the accounting period.

Analysis of Cash Flow Statement determines firm’s ability to generate cash from operations, its capacity to meet cash obligations and its future financing needs. It indicates firm’s success in investing activities, and determines the magnitude, fluctuations and causes of the positive or negative operating cash flow.