

## Accounting: Cash Flow Statement

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**Abstract:** A cash flow statement is prepared by an entity; it is one of the most important statements. It shows cash receipts from major sources and cash payments for major uses during a period. It may be prepared at quarterly intervals but at least at yearly intervals. It provides useful information about an entity's activities in generating cash from operations. It informs about programme to repay debts, distribute dividends or reinvest to maintain or expand its operating capacity. It gives also information about its financing activities, both debt and equity, and about its investment in fixed assets or current assets other than cash. In other words, a cash flow statement lists down various items and their respective magnitude which bring about changes in the cash balance between two balance sheet dates. All the items whether current or non-current which increase or decrease the balance of cash are included in the cash flow statement. Therefore, the effect of changes in the current assets and current liabilities during an accounting period on cash position is assessed from its perusal. The depiction of all possible sources and applications of cash in the cash flow statement helps the financial manager in short-term financial planning in a significant manner; interest payment on debentures and dividend pay-off to shareholders can be met out of cash only.

*This Article is based on the practice followed and instruction for its preparation contained in the various text books for the guidance of the students and accountants. It is hoped that the content of this Article would help the readers to understand Cash-flow statement properly.*

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### I. Introduction:

Cash flow statement is financial reprint which provides information to investors, creditors and others, useful in making rational decisions. The ultimate success or failure of the business depends upon the amount of cash generated. This objective of providing timely information is sought to be met by preparing a cash flow statement. It shows the liquidity position of an entity. Projected cash budget is prepared for a project for the future 10 years or so to assess the financial viability of the project. Bankers insist on its preparation and closely scrutinize it before taking decision for committing funds in financing the new Project.

#### Objective:

An effort is made in this article to describe the Cash-flow statement in detail as to how it is prepared, its limitations as a financial document, its importance as well as distinction between it and the Funds-flow statement. Exercises have been included to explain its computation.

### II. Funds-Flow And Cash-Flow Statements - Distinction

The main differences between a funds-flow statement and a cash-flow statement are described below:

**Concept of Funds:** While a Funds-flow statement is prepared on the basis of wider concept of funds i.e., net working capital (excess of current assets over current liabilities), Cash-flow statement is based upon narrower concept of funds i.e. cash only.

**Basis of Accounting:** A Funds-flow statement can also be distinguished from a Cash-flow statement from the point of view of the basis of accounting used for preparing these statements. A Fund-flow statement is prepared on the accrual basis of accounting, whereas a Cash-flow statement is prepared on cash basis of accounting. Due to this reason, some adjustments are necessary like for income received in advance, income outstanding, pre-paid expenses and outstanding expenses; these adjustments are made to compute cash earned from operations of the business. No such adjustments are made while computing funds from operations in the Funds-flow statement.

**Mode of Preparation:** A Funds-flow statement depicts the sources and application of funds. If the total of sources is more than that of applications, then it represents increase in net working capital. On the other hand if the total of applications of funds is more than that of sources then the difference represents decrease in net

working capital. A Cash-flow statement depicts opening and closing balance of cash as well as inflows and outflows of cash. In a Cash-flow statement, all the inflows of cash are added to the opening balance of cash and from the resultant total, all the outflows of cash are deducted. The resultant balance is the closing balance of cash. A cash flow statement is just like a cash account which starts with opening balance of cash on the debit side to which receipts of cash are added and from the resultant total, the total of all the payments of cash (shown on the credit side) is deducted to find out the closing balance of cash.

#### **Treatment of Current Assets and Current Liabilities:**

While preparing a funds flow statement the changes in current assets and current liabilities are not disclosed in the Funds-flow statement rather these changes are shown in a separate statement known as schedule of changes in working capital. In a Cash-flow statement, no distinction is made between current assets and fixed assets, and current liabilities and long-term liabilities. All changes are summarized in the cash flow statement.

#### **Usefulness in Planning:**

A Cash-flow statement aims at helping the management in the process of short-term financial planning. A Cash-flow statement is useful to the management in assessing its ability to meet its short-term obligations such as trade creditors, bank loans, interest on debentures, and dividend to shareholders and so on. A Funds-flow statement is very helpful in intermediate and long-term planning, because though it is difficult to plan cash resources for two, three or more years ahead yet one can plan adequate working capital for future periods.

#### **Uses and Importance of Cash Flows Statements**

Cash flow statements are of great importance to a financial manager. The information contained in cash flow statement can help the management in the field of short run financial planning and cash control. Some of the important advantages of Cash-flow statements are discussed below:

- 1) The projected cash flow statements disclose surplus or shortage of cash well in advance. This helps in arranging surplus cash as bank deposits or investments in marketable securities for short periods. Should there be shortage of cash, arrangement can be made for raising the bank loan or sell marketable securities.
- 2) Cash-flow statements are of extreme help in planning liquidation of debt replacement of plants and fixed assets and similar other decisions requiring outflow of cash from the business as they provide information about the cash generating ability of the business.
- 3) The cash flow statement pertaining to a particular year compared with the budget for that year reveals the extent to which the actual sources and applications of cash were in consonance with the budget. This exercise helps in refining the planning process in future.

The inter-firm and temporal comparison of cash flow statements reveals the trend in the liquidity position of a firm in comparison to other firms in the industry. It can serve as a pointer to the need for taking corrective action if it is observed that the management of cash in the firm is not effective.

Cash-flow statements are more useful in short-term financial analysis as compared to fund flow statements since in the short run it is cash which is more important for executing plans rather than working capital.

#### **Limitations of Cash Flows Statements**

Firstly, the possibility of 'window-dressing' in cash position is more than in the case of working capital position of a business. The cash balance can easily be maneuvered by deferring purchases and other payments, and speeding up collections from debtors before the balance sheet date. The possibility of such maneuvering is lesser in respect of working capital computation. Therefore, a funds-flow statement which shows reasons responsible for the changes in the working capital presents a more realistic picture than in the cash-flow statement.

Secondly, the liquidity position of a business does not depend upon cash position only. In addition to cash, it is also dependent upon those assets, which can be converted into cash. Exclusion of these assets while assessing the liability of a business obscures the true reporting of the ability of business in meeting its liabilities on due dates.

Thirdly, equating cash generated from the operations of the business with the net operating income of the business is not fair; while computing cash generated from business operations, depreciation on fixed assets is excluded. This treatment leads to mis-match between the expenses and revenues while determining the business results as no charge is made in the profit and loss account for the use of fixed assets.

Fourthly, relatively larger amount of cash generated from business operations vis-à-vis net profit earned may prompt the management to pay higher rate of dividend, which, in turn, may affect the financial health of the firm adversely.

**Procedure for Preparing a Cash Flow Statement**

Cash-flow statement shows the impact of various transactions on cash position of a firm. It is prepared with the help of financial statements, i.e. balance sheet and profit and loss account and some additional information. A cash-flow statement starts with the opening balance of cash - and balance of cash in hand and cash balance at bank - all the inflows of cash are added to the opening balance and the outflows of cash are deducted from the resultant total. The balance, i.e. opening balance of cash and bank balance plus inflows of cash minus outflows of cash is reconciled with the closing balance of cash. The preparation of cash flow statement involves determining of:

- a) Inflows of cash
- b) Outflows of cash

**a) Sources of Cash-Flows:**

The main sources of cash in-flows are:

- 1) Cash flow from operations
- 2) Increase in existing liabilities or creation of new liabilities
- 3) Reduction in or sale of Assets
- 4) Non-Trading Receipts

**b) Application of Cash**

- 1) Cash lost in operation
- 2) Decrease in or discharge of liabilities
- 3) Increase in or purchase of assets
- 4) Non-Trading Payments. Generally, Cash-flow statement is prepared in two forms:
  - a) Report Form
  - b) T Form or an Account Form or Self-Balancing Type

**SPECIMEN OF REPORT FROM OF CASH FLOW STATEMENT**

Cash balance in the beginning		
Rials		
Add: Cash Inflows like:		
Cash flow from operations		
Sale of assets		
Issue of shares		
Issues of debentures		
Raising of loans		
Collection from debtors		
Non-Trading receipts such as:		
Dividend Received		
Income-Tax Refund		
Less: Applications or Outflows of Cash:		
Redemption of Preference shares		
Redemption of debentures		
Repayment of loans		
Purchase of assets		
Payment of dividend		
Payment of taxes		
Cash lost in operations		
Cash balance at the end		

**Specimen Of T Form Or An Account Of Cash Flow Statement**

	Rials		Rials
Cash balance in the beginning		Outflow of cash:	
Add : Cash inflows:		Redemption of Preference Shares	
Cash flow from operation			
Sale of Assets		Redemption of Debentures	
Issue of Shares		Repayment of Loans	
Issue of Debentures		Purchase of Assets	
Raising of Loans		Payment of Dividends	
Collection from Debtors		Payment of Tax	
Dividends Received		Cash lost in Operations	
Refund of Tax		Cash Balance in the end	

**a). SOURCES OF CASH INFLOWS****1) Cash from Operations or Cash Operating Profit**

Cash from trading operations during the year is a very important source of cash inflows. The net effect of various transactions in a business during a particular period is either net profit or net loss. Usually, net profit results in inflow of cash and net loss in outflow of cash. But it does not mean that cash generated from trading operations in a year shall be equal to the net profit or that cash lost in operations shall be identical with net loss. It may either be more or less than net profit/loss. Even when there may be a net loss in a business, but there may be a cash inflow from operations. It is so because of certain non-operating (expenses or incomes) charged to the income statement, i.e. profit and loss account.

**Method to calculate Cash from Operations or Cash Operating Profit**

There are three methods of determining cash from operations:

**a) From Cash Sales:**

Cash from operations can be calculated by deducting cash purchases and cash operating expenses from cash sales, i.e. cash from operations =

$$(\text{Cash Sales}) - (\text{Cash Purchases} + \text{Cash Operating Expenses})$$

Cash sales are calculated by deducting credit sales or increase in receivables from the total sales. From the cash sales, the cash purchases and cash operating expenses are known/given, any decrease in outstanding expenses or increase in pre-paid expenses should be deducted from the corresponding figure.

**b) From Net Profit/Net Loss**

Cash from operations can also be calculated with the help of net profit or net loss. Under this method, net profit or net loss is adjusted for non-cash and non-operating expenses and incomes as follows:

**Calculating of Cash from Trading Operations**

Items	Amount
Net profit (as given)	
<b>Add:</b> Non-cash and non-operating items, already debited to P&L A/c	
Deprecation	
Transfer to Reserves	
Transfer of Provisions	
Goodwill written-off	
Preliminary expenses written -ff	
Other intangible assets written-off	
Loss on the sale or disposal of fixed assets	
Increase in accounts payable	
Decrease in pre-paid expenses	
<b>Less:</b> Non-cash and non-operating items, already credited to P&L A/c	
Increase in Accounts Receivable	
Decrease in Outstanding Expenses	
Increase in Pre-paid Expenses	
Cash from Operations	

**c) Cash Operating Profit**

Cash operating profit is also calculated with the help of net profit or net loss. The difference in this method as compared to the above discussed methods is that increase or decrease in accounts payable and accounts receivable is not adjusted while finding cash from operations and it is directly shown in the cash flow statement as an inflow or outflow of cash as the case may be. The cash from operations so calculated is generally called operating profit.

**Calculation of Cash Operating Profit**

Items	Amount
Net Profit (as given) or Closing Balance of profit and loss A/c	
Add: Non-cash and non-operating items, already debited to P&L A/c:	
Depreciation	
Transfers to Reserves and Provisions	
Writing-off intangible assets	
Outstanding Expenses (current year)	
Pre-paid expenses (previous year)	
Loss on sale of fixed assets	
Dividend Paid, etc.	
Less: Non-cash and non-operating items which have already been credited to P&L A/c:	
Profit on Sale or Disposal of Fixed assets	
Non-trading receipts such as dividend received, rent received, etc.	
Re-transfers from provisions (excess provisions charged back)	
Outstanding income (current year)	
Pre-received income (in previous year)	
Opening balance of P&L A/c	
Cash Operating Profit	

**Note:** Generally the cash operating profit method has to be followed because of its similarity with calculating funds from operations. However, if this method is followed the following two points need particular care:

**(i) Outstanding/Accrued Expenses:** The outstanding/accrued expenses represent those expenses which, although charged to profit and loss account, no cash is paid during the year. For this reason, outstanding/accrued expenses of the current year are added back while calculating cash operating profit. However, if these have been paid during the year, these are shown as outflows of cash in the cash-flow statement.

**(ii) Pre-paid Expenses:** Prepaid expenses are those expenses which are paid in advance and hence result in the outflow of cash but are not charged to profit and loss account because they do not relate to the current period of profit and loss account. For this reason, pre-paid expenses of the current year should be taken as outflows of cash in the cash flow statement. But the expenses if any, paid in the previous year do not involve outflow of cash in the current year but are charged to profit and loss account. Therefore, pre-paid expense of the previous year (related to the current year) should be added back while calculating cash operating profit. In the similar way, we can deal with outstanding and pre-received incomes.

**Illustration:** Calculate cash from operations from the following information:

	Rials.
Sales	70,000
Purchases	40,000
Expenses	8,000
Creditors at the end of the year	15,000
Creditors in the beginning of the year	12,000

**Solution:**

	<b>Rials.</b>	<b>Rials.</b>
Sale		70,000
<b>Less:</b> Purchases	40,000	
Expenses	8,000	48,000
Profit for the year		22,000
Add: Creditors at the end of the year		<u>15,000</u>
		37,000

<b>Less:</b> Creditors at the beginning of the year	<u>12,000</u>	
Cash from operations		<u>25,000</u>

### **2) Increase in Existing Liabilities or Creation of New Liabilities**

If there is an increase in existing liabilities or a new liability is created during the year, it results in the flow of cash into the business. The liability may be either a fixed long-term liability such as equity share capital, preference share capital, debentures, long-term loans, etc. or a current liability such as sundry creditors, bills payable, etc.

#### **The inflow of cash may be either Actual or Notional**

There is an actual inflow of cash when cash is actually received and generally long-term liabilities result into actual inflow of cash, e.g.

For issue of Shares, during the year, the journal entry shall be

Cash A/c	Dr.
To Share Capital A/c	

So, actual cash flows into the business. In the same manner, issue of debentures, raising of loans for cash, etc. result into actual inflows of cash. But when there is credit than cash, there is no inflow of actual cash. The journal entry for the issue of debentures in lieu of purchase of machinery is:

Plant and Machinery A/c	Dr.
To Debenture A/c	

Usually, current liabilities result into inflow of notional cash. For example, increase in sundry creditors implies purchase of goods on credit. In this case, although no cash is actually received, we may say that creditors have given us loans which have been utilized in purchasing goods from them. Hence, increase in the current liabilities may be taken as a source of inflow of cash and decrease in current liabilities as an outflow of cash.

### **3) Reduction in or Sale of Assets**

Whenever a reduction in or sale of any asset, fixed or current, taken place (otherwise than depreciation), it results into inflow of actual or notional cash. There is an actual inflow of cash when assets are sold for cash and notional cash flows in when assets are sold or disposed off on credit. Thus, sale of building, machinery or even reduction in current assets like stocks, debtors, etc. results in inflow of actual or notional cash.

### **4) Non-Trading Receipts**

Sometimes, there may be non-trading receipts like dividend received, rent received, refund of tax, etc. Such receipts or incomes are, although non-trading in nature, result in inflow of cash and hence taken in the cash-flow statement.

### **Applications Of Cash Or Cash Outflows**

**Cash Lost in Operations:** Sometimes, the net result of trading in a particular period is a loss and some cash may be lost during that period in trading operations. Such loss of cash in trading in called cash lost in operations and is shown as an outflow of cash in Cash flow statement.

**Decrease in or Discharge of Liabilities:** Decrease in or discharge of any liability, fixed or current, results in outflow of cash, either actual or notional. For example, when redeemable preference shares are redeemed and loans are repaid, these will amount to outflows of actual cash. But when a liability is converted into another, such as issue of shares for debentures, there will be a notional flow of cash into the business.

#### **Increase in or Purchase of Assets:**

Just like decrease in or sale of assets is a source or inflow of cash, increase or purchase of any asset is an outflow or application of cash.

**Non-Trading Payments:** Payments of non-trading expenses also constitute outflows of cash. For example, payment of dividends, payment of income tax, etc.

**Illustration:** The following details are available from a company.

Liabilities	31-12-11 (Rials)	31-12-12 (Rials)	Assets	31-12-11 (Rials)	31-12-12 (Rials)
Share Capital	70,000	74,000	Cash	9,000	7,800
Debentures	12,000	6,000	Debtors	14,900	17,700
Reserve for doubtful debts	700	800	Stock	49,200	42,700
Trade Creditors	10,360	11,840	Land	20,000	30,000
P&L A/c	10,040	10,560	Goodwill	10,000	5,000
	<b>1,03,100</b>	<b>1,03,200</b>		<b>1,03,100</b>	<b>1,03,200</b>

Additional Information:

- (i) Dividend paid total Rials 3,500  
(ii) Land was purchased for Rials 10,000.

Amount for amortization of goodwill Rials 5,000 and (iii) Debentures paid off Rials 6,000.

Assignment: Prepare Cash Flow Statement

**Solution:**

**Cash Flow Statement**  
(for the year ended 31-12-2012)

	Rials		Rials
Opening balance of Cash on 1-1-2012	9,000	Cash Outflows	
		Purchase of Land	10,000
Add: Cash Inflows		Increase in Debtors	2,800
Issue of Share Capital	4,000	Redemption of Debentures	6,000
Increase in trade creditors	1,480	Dividends paid	3,500
Cash inflow from operations	9,120	Closing balance of cash on 31-12-2010	7,800
Decrease in Stock	6,500		
	<b>30,100</b>		<b>30,100</b>

Working out the Cash-flow Statement as under:

**1) Cash inflow from operations**

Adjusted Profit and Loss A/c

	Rials		Rials
To Dividend (non-operating)	3,500	By Balance b/d	10,040
To Goodwill (non-fund / cash)	5,000	By Cash inflow from operation	9,120
To Reserve for doubtful debts	100		
To Balance c/d	10,560		
	19,160		19,160

Alternatively, it is computed as under:

	Rials
Balance of P&L A/c on 31-12-2012	10,560
Add: Non-fund / cash and non-operating items which have been debited for P&L A/c:	
Dividend paid	3,500
Goodwill written off	5,000
Reserve for doubtful debts	100
	19,160
Less: Opening balance of P&L A/c (on 31-12-2011)	10,040
Cash inflow from operations	9,120

**III. Conclusive Comment:**

There is practice with the analysts to analyse financial statements. The process involves critical examination of details of the accounting information given in the financial statements. For undertaking the

exercise that is for the purpose of analysis, individual items are studied, their interrelationship with other related figures are established, the data is sometimes re-arranged to have better understanding of the information with the help of different techniques or tools evolved for the purpose. In fact, analyzing financial statements is a process of evaluating relationship between component parts of financial statements to obtain a better understanding of firm's financial position and its performance. The principal tools of financial analysis include comparative financial statements, common-size statements, trend analysis, cash-flow statements, ratio analysis and funds-flow statements. Each one serves different purpose and all put together provide comprehensive view.

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