

# Accounting for Financial and Managerial Decision and Control [AFMDC]

## Unit 6 Cash Flow Statement

### Structure

- Preparation and interpretation of cash flow statement: Direct and indirect method

### After the completion of this unit, you should be able to:

- Understand the concept and meaning of cash flow statement
- Describe the importance and objectives of cash flow statement
- Prepare cash flow statement using direct and indirect method
- Evaluate the financial activities of organization using cash flow statement

### 6.1 Concept and meaning of cash flow statement

Cash flow statement of an organization provides users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilities those cash flows (Section 111, NAS 1). It indicates that cash flow information provides amount of cash inflows and outflow in an organization in a particular period of time.

How much cash is generated by business operation? How much cash is spent for current and non-current assets? Where did the company get cash for expenditure? How did the company become able to pay dividend? All these questions are some examples raised by the financial statement users. The Balance Sheet, Income Statement and Statement of Shareholder's Equity do not answer all these questions raised by the users of financial statement. For such, Cash Flow Statement answers these questions.

Cash Flow Statement describes the sources and uses of cash of an organization. It provides information about the inflow and outflow of cash of a firm in an accounting period. It can thus be defined as a statement which explains the change in cash position from one balance sheet date to the next balance sheet date. It shows how much cash a company receives and spends on operating, investing and financing activities. By using the activities related to cash whether generating more cash than it is using.

The Accounting Standard Board, Nepal has set the Nepal accounting standard on cash flow statement. The following items are used in this standard:

1. Cash: Cash comprises cash in hand and demand deposits.
2. Cash Equivalent: Cash equivalents are short-term highly liquid investments that are readily convertible to know accounts of cash which are subject only to insignificant risk of changes in value.
3. Cash flows: Cash flows are inflows and outflows of cash and cash equivalent.

4. Operating Activities: Principal revenue producing activities of the enterprise and other activities that are not investing or financing nature.
5. Investing Activities: Acquisition and disposal of long-term assets and other investment not included in cash activities.
6. Financing Activities: Activities that result in changes in size and composition of equal capital and borrowing of the enterprise.

## **6.2 Objectives of Cash Flow Statement**

The objectives of the cash flow statement are as follows:

- (a) to provide information about cash inflows and outflows in a particular time period;
- (b) to show amount of cash receipts from customers and paid to employees and suppliers;
- (c) to provide information about tax and interest paid;
- (d) to show amount generated from extraordinary activities;
- (e) to provide information about cash generated (used) from (to) investing activities; and
- (f) to show cash used (generated) to (from) financing activities.

## **6.3 Importance of Cash Flow Statement**

The cash flow statement is widely used as one of the best indicators of the financial situation of an organization. The importance's of the cash flow statement are under:

- (a) lenders able to know about the capacity of an organization to cash pay back the borrowed money;
- (b) suppliers evaluate about credit pay back capacity of the organization;
- (c) investors able to assess about the dividend payment capacity and business expansion capacity;
- (d) civil society determines the organization's expenses capacity for social cause;
- (e) allows comparison of the financial status of the organization over different periods; and
- (f) especially with respect to financial health, it allows comparison between multiple companies.

## **6.4 Preparation of Cash Flow Statement**

Cash Flow Statement is distinct from the Income Statement and Balance Sheet. It does not include the amount of future incoming and outgoing cash that has been recorded on credit. Hence, cash will not be same as net income, which is affected by cash sales and credit sales.

A statement cash flows contains information about the cash of cash into and out of a company. It is comprised of three section which are as under:

- (a) Cash flows from operating activities
- (b) Cash flows from investing activities
- (c) cash flows from financing activities

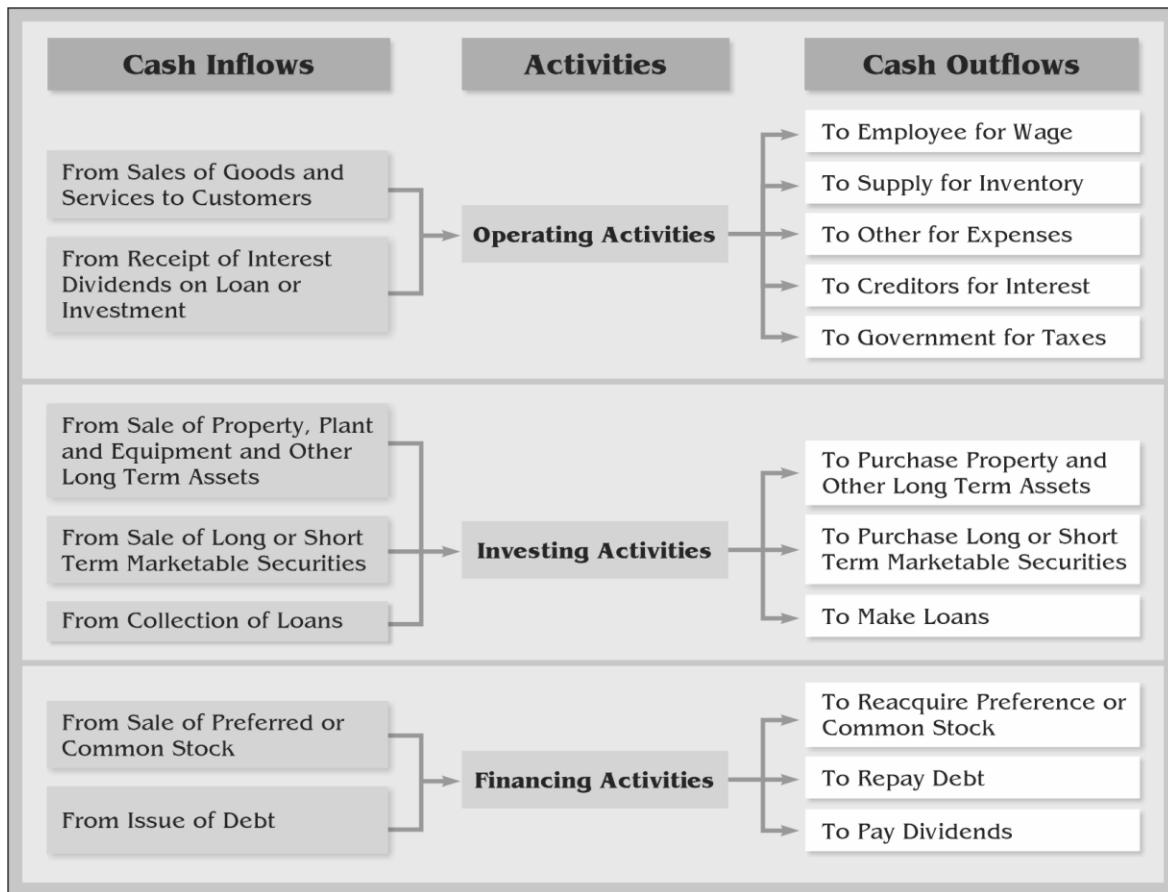
According to Nepal Accounting Standards (NAS-03) issued by Nepal Accounting Standard Board "the cash flow statement should report cash flow during the period classified by operating, investing and financing activities.

On the basis of above three categories, the following four steps are to be completed:

<b>Step 1 :</b>	To determine cash flows from operating activities
<b>Step 2 :</b>	To determine cash flows from investing activities
<b>Step 3 :</b>	To determine cash flows from financing activities
<b>Step 4 :</b>	To find out change on cash and to complete statement

**Table 1**

**Cash inflows and outflows under operating, investing and financing activities**



(Source: Dangol and Dangol, 2019)

The main items of direct and indirect methods of illustrating cash flow statement, according to the NAS-03 issued by Accounting Standards Board, for manufacturing organization are summarized below:

### Direct Method Cash Flow Statement

#### A: Cash Flow from Operating Activities.

Cash Receipts from Customers (Working Note – 1)		XX
Cash Paid to Supplier and Employees (Working Note- 2)	(-)	<u>XX</u>
Cash Generated from Operations		<u>XX</u>
Income Tax Paid	(-)	<u>XX</u>
Cash flow Before Extra Ordinary Items		<u>XX</u>
Proceeds from Insurance Settlement	(+)	<u>XX</u>
Net Cash from Operating Activities		<u>XX</u>

#### B: Cash Flow from Investing Activities

Purchase of Fixed Assets / Equipment	(-)	XX
Proceeds from Sale of Assets /equipment	(+)	XX
Interest Received	(+)	XX
Dividend Received	(+)	<u>XX</u>
Net Cash from Investing Activities		<u>XX</u>

#### C: Cash Flow from Financing Activities

Proceeds from Issuance of Share Capital	(+)	XX
Proceeds from Long Term Borrowings	(+)	XX
Repayments of Long Term Borrowing	(-)	XX
Interest Paid	(-)	XX
Dividend Paid	(-)	<u>XX</u>
Net Cash from Financing Activities		<u>XX</u>
<b>Net Increase in Cash and Cash Equivalents (A + B + C)</b>		<u>XX</u>
Cash and Cash Equivalents at the Beginning of Period*	(+)	XX
Cash and Cash Equivalents at the End of Period*		<u>XX</u>

#### Working note 1

##### Cash Receipts from Customers

Sales		XX
Add: Decreased in Account Receivable/Debtors	(+)	XX
Less: Increased in Account Receivable/Debtors	(-)	XX
Add: Increased in Doubtful Debts.	(+)	XX
Less: Decreased in Doubtful Debts	(-)	XX
Add: Bad Debts Recovered	(+)	XX
Less: Current Year Bad Debts	(-)	<u>XX</u>
Total		<u>XX</u>

## WORKING NOTE 2

### Cash Paid to Suppliers and Employees

Cost of Sales		XX
Add: Administration and Selling Expenses	(+)	XX
Add: Increase in Inventory	(+)	XX
Less: Decreased in Inventory	(-)	XX
Less: Increased in Account Payable/Creditors	(-)	XX
Add: Decreased in Account Payable/Creditors	(+)	XX
Less: Increased in Outstanding Expenses	(-)	XX
Add: Decreased in Outstanding Expenses	(+)	XX
Add: Increased in Pre-paid Expenses	(+)	XX
Less: Decreased in Pre-paid Expenses	(-)	<u>XX</u>
<b>Total</b>		<b><u>XX</u></b>

### Indirect Method Cash Flow Statement

#### A. Cash Flow from Operating Activities

Net Profit before Taxation and Extraordinary Item		XX
Adjustment for:	(+)	XX
Depreciation	(+)	XX
Loss on Sales of Assets	(+)	XX
Gain on Sales of Assets	(-)	XX
Interest Expenses	(+)	XX
Interest Income	(-)	XX
Dividend Income	(-)	XX
Foreign Exchange Loss	(+)	<u>XX</u>
Operating Profit before Working Capital Change		XX
Increase in Current Assets	(-)	XX
Decrease in Current Assets	(+)	XX
Increase in Current Liabilities	(+)	XX
Decrease in Current Liabilities	(-)	<u>XX</u>
Cash Generated from Operations		XX
Income Tax Paid	(-)	<u>XX</u>
Cash Flow before Extra Ordinary Item		XX
Proceed from Insurance Settlement	(+)	<u>XX</u>
Net Cash from Operating Activities		<b><u>XX</u></b>

#### B. Cash Flow from Investing Activities

Purchase of Fixed Assets / Equipment	(-)	XX
Proceeds from Sale of Assets/Equipment	(+)	XX
Interest Received	(+)	XX
Dividend Received	(+)	<u>XX</u>
Net Cash from Investing Activities		<b><u>XX</u></b>

### C. Cash Flow from Financing Activities

Proceeds from Issuance of Share Capital	(+)	XX
Proceeds from Long Term Borrowings	(+)	XX
Repayments of Long Term Borrowing	(-)	XX
Interest Paid	(-)	XX
Dividend Paid	(-)	XX
Net Cash from Financing Activities		<u>XX</u>
<b>Net Increase (Decrease) in Cash &amp; Cash Equivalents</b>		<u>XX</u>
<b>(A + B + C)</b>		
Cash and Cash Equivalents at the Beginning of Period*	(+)	XX
Cash and Cash Equivalents at the End of Period*		<u>XX</u>

\*Consists of cash on hand and balance with banks, investment in money market (short-term) investments.

### Interest and Dividends Treatment

For the treatment of interest and dividend, Nepal Accounting Standards (2003), in Sec. 31, 32, 33 and 34 states as under:

31. Cash flows from interest and dividends received and paid each should be disclosed separately. Each should be classified in a consistent manner from period to period, either operating, investing or financing activities.
32. The total amount of interest paid during a period is disclosed in the cash flow statement whether it has been recognized as an expense in the income statement or capitalized.
33. Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other enterprises. 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. Alternatively, they may be classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or return on investment.
34. Dividends paid may be classified as a financing cash flow because they are a cost of obtaining financial resources. Alternatively, 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.

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