

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

Unit 6

## **Cash Flow Statement**

Lecturer: Dr. Jeetendra Dangol

# Contents

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

# Learning Objectives

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- 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

# Cash Flow Statement

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- 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 (Contd.)

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- 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 outflows in an organization in a particular period of time

# Cash Flow Statement (Contd.)

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

# Cash Flow Statement (Contd.)

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

# Objectives of Cash Flow Statement

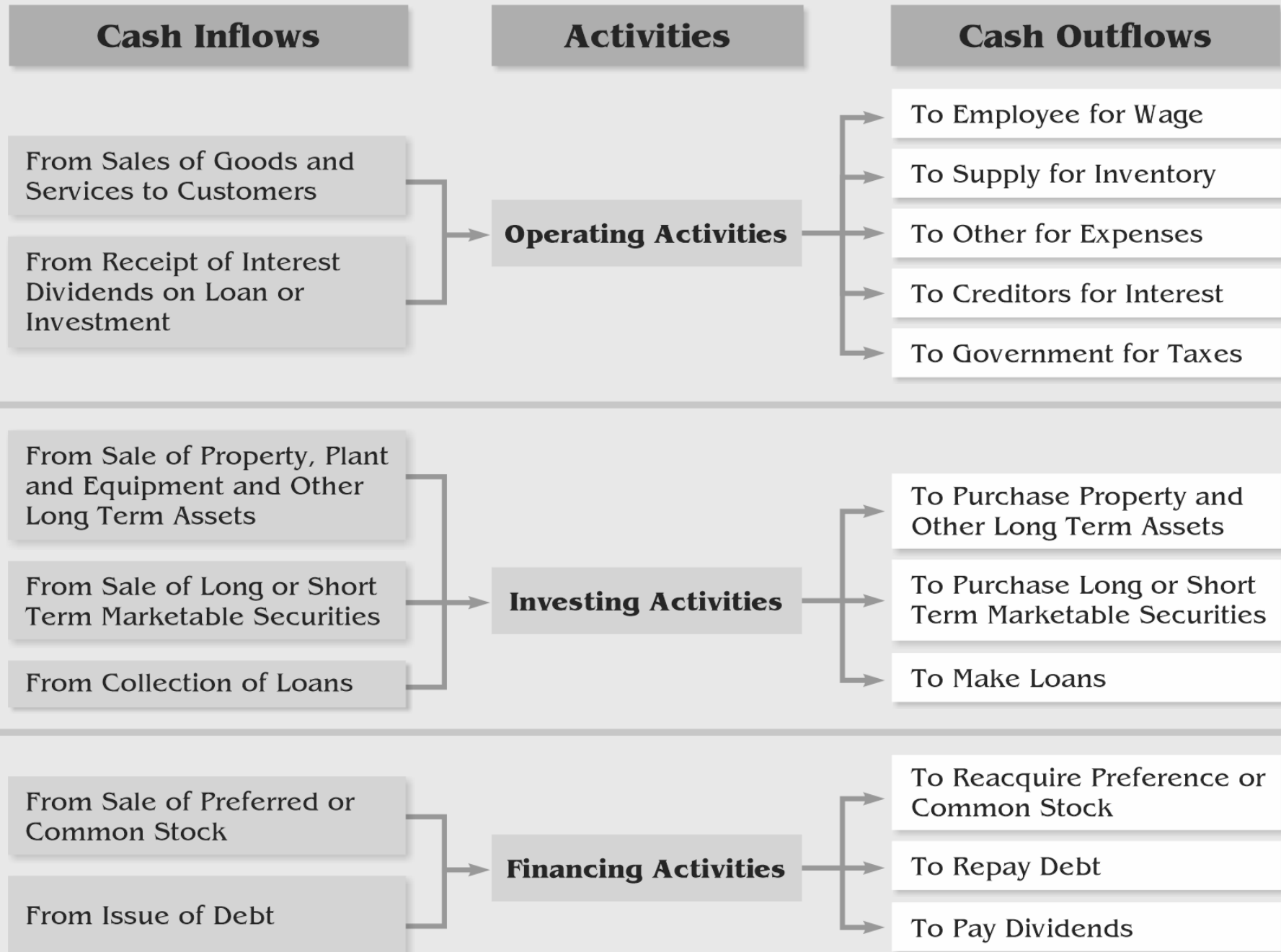
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- a) to provide information about cash inflows and outflows in a particular time period;
- b) to show amount of cash receipts from customers and paid to employees and suppliers;
- c) to provide information about tax and interest paid;
- d) to show 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.

# Importance of Cash Flow Statement

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- 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.



(Source: Dangol and Dangol, 2019)

# Preparation of Cash Flow Statement

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- Direct method
- Indirect method

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

# Preparation of Cash Flow Statement (Direct Method)

## A: Cash Flow from Operating Activities.

Cash Receipts from Customers (Working Note – 1)		<u>XX</u>
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*	(+)	<u>XX</u>
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>
<b>Total</b>		<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>		<u>XX</u>

# Preparation of Cash Flow Statement (Indirect Method)

## 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		<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 (Decrease) in Cash &amp; 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>

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

# Interest and Dividend Treatment

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## Section 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

## Section 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.

# Interest and Dividend Treatment

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## Section 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.

## Section 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

The following are the summarized balance sheets of ABC Company Ltd. as on end of fiscal year, for the two consecutive years 1 and 2.

	Year 2	Year 1
<b>Assets</b>		
Plant and Machinery (Cost)	1,980	1,010
Land and Building (Cost)	1,000	1,000
Long-term Investments	550	550
Short-term Investments	470	85
Sundry Debtors	2,195	2,500
Inventories	1,400	1,300
Interest Receivable	100	65
Cash in Hand	300	500
Cash at Bank	405	300
	<u>8,400</u>	<u>7,310</u>
<b>Liabilities</b>		
Share Capital	2,600	2,150
Reserve and Surplus	1,460	900
15% Debenture	2,000	1,800
Sundry Creditors	440	650
Wages Outstanding	40	20
Income Tax Payable	400	450
<b>Accumulated Depreciation:</b>		
Plant and Machinery	910	840
Land and Building	550	500
	<u>8,400</u>	<u>7,310</u>

### Income Statement for the Period Ending Ashad, year 2

Sales Revenue	45,300
Less: Cost of Sales	<u>39,000</u>
Gross Profit	6,300
Less: Depreciation	(540)
Selling and Administration Expenses	(2,960)
Interest Paid	(300)
Add: Interest Income	65
Dividend Income (Gross)	95
Net Profit before Extra Ordinary Items	<u>2,660</u>
Add: Insurance Settlement Received	10
	<u>2,670</u>
Less: Provision for Income Taxes	<u>(550)</u>
Net Profit after Taxes	<u>2,120</u>

### Additional Information:

- i. 15% Debentures of Rs. 300 was redeemed during year 2.
  - ii. Tax deducted at source on dividends received (included in provision for taxes) amounts to Rs. 15.
  - iii. A plant costing Rs. 500, having accumulated depreciation of Rs. 420 was sold for Rs. 80.
  - iv. During year 2, interim dividend of Rs. 760 was paid; final dividend paid was Rs. 800.
  - v. All sales and purchases are made on credit basis.
- You are required to prepare a cash flow statement.

# Working Note 1: Cash Receipts from Customers

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The cash receipts from customers are affected by bad debts, provision for bad debts, bad debts recovery and discount provided after sales during collection etc. Income statement of ABC company Ltd. shows the total sales amount of Rs. 45,300 in year 2. However, this is not the amount of cash collection from the customer. For such, the comparative balance sheet shows decrease in sundry debtors by Rs. 305. The following calculations show the total cash receipts from customers.

Sales Revenue	Rs. 45,300
Add: Decreased in Sundry Debtors	<u>Rs. 305</u>
Total	<u>Rs. 45,605</u>

## Working Note 2: Cash Paid to Suppliers and Employees

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Cash paid to suppliers and employees are affected by change in inventory, creditors, outstanding expenses, pre-paid expenses and amount of selling and administration expenses paid. ABC Ltd.s' income statement includes selling and administration expenses amounting Rs. 2,960. In the same, balance sheet shows increase in inventory by Rs. 100, decrease in sundry creditors by Rs. 210 and increase in outstanding wages by Rs. 20 respectively. So the cash paid to suppliers and employees can be obtained as follows:

Cost of Sales	Rs. 39,000
Add: Selling and Administration	2,960
Add: Increase in Inventory	100
Add: Decreased in Sundry Creditors	210
Less: Increased in Outstanding Expenses	<u>( 20)</u>
Total	Rs. 42,250

# Working Note 3: Cash Paid Income Taxes

Income statement of ABC Ltd. provides amounting Rs. 550 for income tax purpose. But the income tax payable decrease in 2 year by Rs. 50. So company is assumed to pay Rs. 600 for income tax but paid Rs. 585 after deduction of Rs. 15, advance tax deposited against dividend receipt. It can be calculated as follows:

Provision for Income Tax	Rs. 550
Add: Decrease in Income Tax Payable	Rs. 50
Less: Advance Tax Paid	<u>(Rs. 15)</u>
Total	Rs. 585

It can be shown by T-accounts as under:

Income Tax Payable			
Tax Deduct at Source (On Dividend Received)	15	Opening Balance	450
Income Tax Paid	585	Provision for Tax	550
Closing Balance	400		
	<u>1000</u>		<u>1000</u>

# Working Note 4: Plant and Machinery

During the year 2 the plant and machinery is increased by Rs. 970 and sale of plant costing Rs. 500, book value for Rs. 80 without having any loss and gain. So cash paid for purchase can be calculated as below :

Increase in Plant and Machinery	Rs. 970
Cost of Sale of Plant	<u>Rs. 500</u>
Total Purchase	<u>Rs. 1,470</u>

Plant and Machinery			
Opening Balance	1010	Acc. Dep.	420
Purchase of P/M	1470	(Dep. of Sold Plant & Machinery)	
		Sale of Plant & machinery	80
		Closing Balance	1980
	<u>2480</u>		<u>2480</u>

Accumulated Depreciation Plant and Machinery			
Dep. of Sold Plant & Machinery	420	Opening Balance	840
Closing Balance	910	Depreciation 2 Year	490
	<u>1330</u>		<u>1330</u>

# Working Note 5: Interest Received

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Income statement of ABC Ltd. recognized interest income amounting Rs. 65 in year 2. But balance sheet shows interest receivable increased by Rs. 35. So, the actual cash received against the interest income is amounting Rs. 30 as under:

Interest Income	Rs. 65
Increase in Interest Receivable	<u>(Rs. 35)</u>
Total	<u>Rs. 30</u>

Interest Receivable			
Opening Balance	65	Interest Received	30
Interest Income	65	Closing Balance	100
	<u>130</u>		<u>130</u>

# Working Note 6: Share Capital

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Comparative balance sheet of ABC Ltd shows increments of its share capital by amounting Rs. 450. It means the company issued share capital during the year 2.

## Share Capital

		Opening Balance	2,150
Closing Balance	2,600	Share capital issued	450
	<u>2,600</u>		<u>2,600</u>

# Working Note 7: 15% Debenture

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Comparative balance sheet of ABC Ltd. shows increments of its 15% debenture by amounting Rs. 200. In the same year, it redeemed 15% debenture amounting Rs. 300. So the total cash generated from issuance of debenture is amounting Rs. 500 as under:

Redemption of 15% Debenture	Rs. 300
Increase in 15% Debenture	<u>Rs. 200</u>
Total issue of 15% Debenture	<u>Rs. 500</u>

## 15% Debenture

Redemption	300	Opening Balance	1800
Closing Balance	2000	Issue of New Debenture	500
	<u>2300</u>		<u>2300</u>

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## Working Note 8: Reserve and Surplus and Payment of Dividend

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One final financial transaction occurred during the year 2. Management declared and paid dividend in total Rs. 1,560 with interim dividend Rs. 760 and final dividend Rs. 800 respectively.

### Reserve and Surplus

Dividend Paid	1,560	Opening Balance	900
Closing Balance	1,460	Net Profit	2,120
	<u>3,020</u>		<u>3,020</u>

# Working Note 9: Cash and Cash Equivalents

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Cash and cash equivalents consist of cash on hand and balance with banks, short-term investments as under:

	Year 2	Year 1
Cash in Hand	300	500
Cash at Bank	405	300
Short-term Investments	<u>470</u>	<u>85</u>
Total	<u>1,175</u>	<u>885</u>

## Cash Flow Statement - Direct method

	Rs.	Rs.
<b>A: Cash Flow from Operating Activities:</b>		
Cash Receipts from Customers (Working Note 1)	45,605	
Cash Paid to Suppliers and Employees (Working Note 2)	<u>(42,250)</u>	
Cash Generated from Operation	3,355	
Income Tax Paid (Working Note 3)	<u>(585)</u>	
Cash Flow before Extra-ordinary Item	2,770	
Proceeds from Insurance Settlement	<u>10</u>	
Net Cash from Operating Activities		2,780
<b>B: Cash Flow from Investing Activities:</b>		
Purchase of Plant and Machinery (Working Note 4)	(1,470)	
Proceed from Sale of Plant and Machinery (Working Note 4)	80	
Interest Received (Working Note 5)	30	
Dividend Received (95 – 15)	<u>80</u>	
Net Cash used in Investing Activities		(1,280)
<b>C: Cash Flow from Financing Activities:</b>		
Proceed from Issuance of Share Capital (Working Note 6)	450	
Proceed from Issuance of 15% Debenture (Working Note 7)	500	
Redemption of 15% Debenture (Working Note 7)	(300)	
Interest Paid	(300)	
Dividend Paid (Interim + Final) (Working Note 8)	<u>(1,560)</u>	
Net Cash used in Financing Activities		<u>(1,210)</u>
Net Increase in Cash and Cash Equivalent (A + B +C)		290
Cash and Cash Equivalents at Beginning of Year 2 (Working Note 9)		<u>885</u>
Cash and Cash Equivalents at the End of Year 2 (Working Note 9)		1,175

## Cash Flow Statement – Indirect Method

### A: Cash Flow from Operating Activities

	Rs.	Rs.
Net Profit before Taxation and Extra Ordinary Item	2,660	
Adjustment For:		
Depreciation	540	
Interest Income	(65)	
Dividend Income	(95)	
Interest Expenses	<u>300</u>	
Operating Profit before Working Capital Change	3,740	
Decrease in Sundry Debtors	305	
Increase in Inventories	(100)	
Increase in Wages Outstanding	20	
Decrease in Creditors	<u>(210)</u>	
Cash Generated from Operations	3,355	
Income Tax Paid	<u>(585)</u>	
Cash Flow before Extra Ordinary Item	2,770	
Proceed from Insurance Settlement	<u>10</u>	
Net Cash from Operating Activities		2,780

B: Cash Flow from Investing Activities:		
Purchase of Plant and Machinery (Working Note 4)	(1,470)	
Proceed from Sale of Plant and Machinery (Working Note 4)	80	
Interest Received (Working Note 5)	30	
Dividend Received (95 – 15)	<u>80</u>	
Net Cash used in Investing Activities		(1,280)
C: Cash Flow from Financing Activities:		
Proceed from Issuance of Share Capital (Working Note 6)	450	
Proceed from Issuance of 15% Debenture (Working Note 7)	500	
Redemption of 15% Debenture (Working Note 7)	(300)	
Interest Paid	(300)	
Dividend Paid (Interim + Final) (Working Note 8)	<u>(1,560)</u>	
Net Cash used in Financing Activities		<u>(1,210)</u>
Net Increase in Cash and Cash Equivalent (A + B +C)		290
Cash and Cash Equivalents at Beginning of Year 2 (Working Note 9)		<u>885</u>
Cash and Cash Equivalents at the End of Year 2 (Working Note 9)		<u>1,175</u>

# Analyzing Cash Flow Statement

## (Interpretation of Cash Flow Statement)

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- to know the cash generating capacity of a firm as a whole.
- to find out the main cash generation items.
- to know about the adequacy of cash flows from operating activities to meet the long-term debt.
- to determine rate of return on total assets investment activity,
- to ascertain the remaining amount of cash from operating activity,
- to test the capacity of the firm for financing fixed assets from internal flow of cash.
- to assess deviation of cash and cash equivalents from net earnings
- helps in financial planning and formulation dividend policy
- free cash flow

# Analyzing Cash Flow Statement

## (Interpretation of Cash Flow Statement)

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Ratio:

1. Cash realization ratio = Cash generated by operations / Net income  
[Ratio >1, signal high-quality earnings]
2. Interest coverage ratio = Pre-tax income before interest / Interest expenses  
[or] = [Cash generated by operations + Tax + Interest] / Interest expenses
3. Sources and uses of cash in percentage
4. For testing creditworthiness  
Ratio of cash generated by operations to total debt  
= Cash generated by operations / Total debt (long-term + short-term)  
[Ratio must be at least 1:1]

# Analyzing Cash Flow Statement

## (Interpretation of Cash Flow Statement)

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### 5. Free cash flow

The amount of cash that a company has left over to use for other purposes after paying capital expenditure for additional fixed assets, dividend paid interest paid. It is an important measurement since it shows how efficient a company might have generating cash.

Free cash flow = Cash from operations – (1) capital expenditure for maintenance of existing productive capacity – (2) schedule debt payment including interest – (3) normal dividend payment

- If positive, the amount indicates cash available to retire additional debt, increase dividends or invest in new lines of business
- If negative, it indicates the amount of financing needed just to support operations and programs (growth is not possible)

# Analyzing Cash Flow Statement (Interpretation of Cash Flow Statement)

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Some selected comments and conclusions

- The performance of activities (various resources) were fluctuated over periods
- There was a sharp increased (decreased) in the relative share of dividends, profit and borrowings in the current year
- Cash used in investing activities offset the cash from financing activities
- Cash available from operating activities were not sufficient to meet debt payment
- Heavy balance in cash and cash equivalents indicate either poor cash management or shortfall in performance or both

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**Thank You**