FUNDS FLOW STATEMENT

Introduction

At the end of each accounting period, preparation and presentation of financial statements are undertaken with an objective of providing as much information as possible for the public. The balance sheet presents a snapshot picture of the financial position at a given point of time and the income statement shows a summary of revenues and expenses during the accounting period. Though these are significant statements especially in terms of the principal goals of the enterprise, yet there is a need for one more statement which will indicate the changes and movement of funds between two balance sheet dates which are not clearly mirrored in the balance sheet and income statement. That statement is called as funds flow statement. The analysis which studies the flow and movement of funds is called as funds flow analysis. Similarly one more statement has to be prepared known as cash flow statement. This requires the doing of cash flow analysis. The focus of cash flow analysis is to study the movement and flow of cash during the accounting period.

Concept of Funds

How are funds defined? Perhaps the most ambiguous aspect of funds flow statement understands what is meant by funds. Unfortunately there is no general agreement as to precisely how funds should be defined. To a lay man the concept of funds means `cash'. According to a few, `funds' means `net current monetary assets' arrived at by considering current assets (cash + marketable securities + short term receivables) minus short term obligations. A third view, which is the most acceptable one, is that concept of funds means `working capital' and in this lesson the term `funds' is used in the sense of Working capital.

Working Capital Concept of Funds

The excess of an enterprise's total current assets over its total current liabilities at some point of time may be termed as its net current assets or working capital. To illustrate this, let us assume that on the balance sheet date the total current assets of an enterprise are Rs.3,00,000 and its total current liabilities are Rs.2,00,000. Its working capital on that date will be Rs.3,00,000 – Rs.2,00,000 = Rs...1,00,000. It follows from the above, that any increase in total current assets or any decrease in total current liabilities will result in a change in working capital.

Flow of Funds

The term `flow' means change and therefore, the term `flow of funds' means `change in funds' or `change in working capital'. According to manmohan and goyal, "the flow of funds" refers. To movement of funds described in terms of the flow in and out of the working capital area. In short, any increase or decrease in working capital means `flow of funds'. Many transactions which take place in a business enterprise may increase its working capital, may decrease it or may not affect any change in it. Let us consider the following examples.

(i) Purchased Machinery For Rs.3,00,000: The effect of this transaction is that working capital decreases by 3,00,000 as cash balance is reduced. This change (decrease) in working capital is called as application of funds. Here the accounts involved are current assets (cash a/c) and fixed asset (machinery a/c).

(ii) Issue of Share Capital of Rs.10,00,000: This transaction will increase the working capital as cash balance increases. This change (increase) in working capital is called as source of funds. Here the two accounts involved are current assets (cash a/c) and long-term liability (share capital a/c).

(iii) Sold Plant For Rs.3,00,000: This transaction will have the effect of increasing the working capital by rs.3,00,000 as the cash balance increases by rs.3,00,000. It is a source of funds. Here the accounts involved are current assets (cash a/c) and fixed assets (plant a/c).

(iv) Redeemed Debentures worth Rs.1,00,000: This transaction has the effect of reducing the working capital, as the redemption of debentures results in reduction in cash balance. Hence this is an example of application of funds. The two accounts affected by this transaction are current assets (cash a/c) and long-term liability (debenture a/c).

(v) Purchased Inventory Worth Rs.10,000: This transaction results in decrease in cash by rs.10,000 and increase in stock by rs.10,000 thereby keeping the total current assets at the same figure. Hence there will be no change in the working capital (there is no flow of funds in this transaction). Both the accounts affected are current assets.

(vi) Notes Payable Drawn by Creditors Accepted for Rs.30,000: The effect of this transaction on working capital is nil as it results in increase in notes payable (a current liability) and decreases the creditors (another current liability). Since there is no change in total current liabilities there is no flow of funds.

(vii) Building Purchased for Rs.30,00,000 And Payment Is Made By Shares: This transaction will not have any impact on working capital as it does not result in any change either in the current asset or in the current liability.

Hence there is no flow of funds. The two accounts affected are fixed assets (building a/c) and long term liabilities (capital a/c).

(a) Sources and Application of Funds: the following are the main sources of funds:

(i) Funds From Operations: the operations of the business generate revenue and entail expenses. Revenues augment working capital and expenses other than depreciation and other amortizations. The following adjustments will be required in the figures of net profit for finding out the real funds from operations:

		Rs.
Funds from Operations Net profit for the year		x x x
Add*: depreciation of fixed assets		x x x
Preliminary expenses, goodwill, etc. Written off		x x x
Loss on sale of fixed assets	x x x	
Transfers to reserve	x x x	
Less: profit on sale or revaluation		x x x
Dividends received, etc.		x x x
Funds from operations	x x x	

*these items are added as they do not result in outflow of funds.

In case of 'net loss' for the year these items will be deducted.

(ii) Issue Of Share Capital: an issue of share capital results in an inflow of funds.

(iii) Long-Term Borrowings: when a long-term loan is taken, there is an increase in working capital because of cash inflow. A short term loan, however, does not increase the working capital because a short-term loan increases the current assets (cash) and the current liability (short term loan) by the same amount, leaving the size of working capital unchanged.

(iv) Sale Of Non-Current Assets: when a fixed asset or a long-term investment or any other non-current asset is sold, there will be inflow represented by cash or short-term receivables.

(b) Uses Of Funds: The following are the main uses of funds:

(i) Payment Of Dividend: the transaction results in decrease in working capital owing to outflow of cash.

(ii) Repayment Of Long-Term Liability: The repayment of long-term loan involves cash outflow and hence it is used for working capital. The repayment of a current liability does not affect the amount of working capital because it entails an equal reduction in current liabilities and current assets.

(iii) Purchase Of Non-Current Assets: when a firm purchases fixed assets or other non-current assets, and if it pays cash or incurs a short-term debt, its working capital decreases. Hence it is a use of funds.

Importance and Utility of Funds Flow Analysis

Funds flow analysis provides an insight into the movement of funds and helps in understanding the change in the structure of assets, liabilities and owners' equity. This analysis helps financial managers to find answers to questions like:

(i) How far capital investment has been supported by long term financing?
(ii) How far short-term sources of financing have been used to support capital investment?
(iii) How much funds have been generated from the operations of a business?
(iv) To what extent the enterprise has relied on external sources of financing?
(v) What major commitments of funds have been made during the year?
(vi) Where did profits go?
(vii) Why were dividends not larger?
(viii) How was it possible to distribute dividends in excess of current earnings or in the presence of a net loss during the current period?
(ix) Why are the current assets down although the income is up?
(x) Has the liquidity position of the firm improved?
(xi) What accounted for an increase in net current assets despite a net loss for the period?
(xii) How was the increase in working capital financed?

Preparation of Funds Flow Statement Two statements is involved in funds flow analysis.

(I) Statement Or Schedule Of Changes In Working Capital
(II) Statement Of Funds Flow

(A) Statement Of Changes In Working Capital: This statement when prepared shows whether the working capital has increased or decreased during two balance sheet dates. But this does not give the reasons for increase or decrease in working capital. This statement is prepared by comparing the current assets and the current liabilities of two periods.

Format of Statement showing Changes in Working Capital

Items	As on	As on	Changes Increase Decrease
Current Assets Cash Balances Bank Balances Marketable Securities Stock in Trade Pre-paid Expenses **Current Liabilities** Bank Overdraft Outstanding Expenses Accounts Payable Provision for Tax Dividend Increase / Decrease in Working Capital			

(B) Funds Flow Statement:

Funds Flow Statement is also called as Statement of Changes in Financial Position or Statement of Sources and Applications of Funds or where got, where gone Statement. The purpose of the funds flow statement is to provide information about the enterprise'sinvesting and financing activities. The activities that the funds flow statement describes can beclassified into two categories:

(i) Activities that generate funds, called Sources, and
(ii) Activities that involve spending of funds, called Uses.

When the funds generated are more than funds used, we get an increase in working capital and When funds generated are lesser than the funds used, we get decrease in working capital. The

(b) Funds Flow Statement: Funds flow statement is also called as statement of changes in financial position or statement of sources and applications of funds or where got, where gone statement. The purpose of the funds flow statement is to provide information about the enterprise's investing and financing activities. The activities that the funds flow statement describes can be classified into two categories:

(i) Activities that generate funds, called sources, and

(ii) Activities that involve spending of funds, called uses. When the funds generated are more than funds used, we get an increase in working capital and when funds generated are lesser than the funds used, we get decrease in working capital. The increase or decrease in working capital disclosed by the schedule of changes in working capital should tally with the increase or decrease disclosed by the funds flow statement.

The funds flow statement may be prepared either in the form of a statement or in `t' shape form. When prepared in the form of statement it would appear as follows:

Sources of Funds	Amounts	Applications of Funds	Amounts
* Funds from operation Issue of shares Issue of Debentures Long-term borrowings Sale of fixed assets * Decrease in workingcapital		Funds lost in operations Redemption of Preference Shares Redemption of Debentures Payment of other longtermLoans Purchase of fixed assets Payment of dividend, tax,etc.	
TOTAL		TOTAL	

Procedures for Preparing Funds Flow Statement

Funds flow statement is a method by which we study changes in the financial position of a business enterprise between beginning and ending financial statement dates.

Hence, the funds flow statement is prepared by comparing two Balance sheets and, with the help of such, other information derived from the accounts, as may be needed. The preparation of a funds flow statement consists of three steps

1. Schedule of changes in working capital which shows whether there is increase in working capital or decrease in working capital.

2. Funds from operation or adjusted profit and loss account which exhibits funds from operation

3. Funds flow statement reveals the sources and uses of funds

The preparation of Statement of Schedule of Changes in Working Capital is as follows.

The statement of schedule of changes in working capital deals with the current assets and current liabilities alone, as they are shown in the Balance Sheets of the current and the previous years. All non-current assets and non-current liabilities, and profits and losses ignore additional information available. Each current asset and current liability in the period's Balance sheet is compared with that shown in the previous period's Balance Sheet. Increase or decrease in each of the assets and liabilities is noted. The effect of such increase or decrease during the period in each item is recorded individually on the working capital. Finally, the overall change in the working capital is calculated. It is possible that working capital might have increase or decrease as the final result.

The following interpretations have to be taken into consideration when schedule of changes in working capital is prepared.

1. An increase in current assets and decrease in current liabilities will result in increase in working capital.

2. A decrease in current assets and increase in current liabilities will result in decrease in working capital.

CASH FLOW STATEMENT: AS-3

Cash Flow Statement is a statement that shows flow of cash and cash equivalents during a given period of time. Cash flow statement shows the net increase or net decrease of cash and cash equivalents under each activity i.e. operating activity, investing activity, financing activity.

The cash flow statement is one of the three main financial statements, the others being the income statement and the balance sheet. Businesses regularly measure their cash flow by preparing a cash flow statement.

Utility of Cash Flow Analysis

Cash flow analysis yields the following advantages:

1. It is very helpful in understanding the cash position of the firm. This would enable the management to plan and coordinate the financial operations properly.
2. Since it provides information about cash which would be available from operations the management would be in a position to plan repayment of loans, replacement of assets, etc.
3. It throws light on the factors contributing to the reduction of cash balance inspite of increase in income and vice versa.
4. A comparison of the cash flow statement with the cash budget for the same period helps in comparing and controlling cash inflows and cash outflows.

Limitations of Cash Flow Analysis

Cash flow analysis is a useful tool of financial analysis. However, it has its own limitations. These limitations are as under:

(1) Cash flow statement cannot be equated with the Income Statement. An Income Statement takes into account both cash as well as non-cash items and, therefore, net cash flow does not necessarily mean net income of the business.

(2) The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments.

(3) Cash flow statement cannot replace the Income Statement or the Funds Flow Statement. Each of them has a separate function to perform.

In spite of these limitations, it can be said that cash flow statement is a useful supplementary instrument. It discloses the volume as well as the speed at which the cash flows in the different segments of the business. This helps the management in knowing the amount of capital tied up in a particular segment of the business. The technique of cash flow analysis, when used in conjunction with ratio analysis, serves as a barometer in measuring the profitability and financial position of the business.

However cash flow analysis is not without limitations. The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments. Further cash flow statement cannot replace the income statement or funds flow statement. Each of them has a separate function to perform.

The cash flow statement reports the sources of cash, as well as its usage, in three different categories:

Operating activities

A company's operating activities are the primary means to generate revenue. Cash flow for operating activities generally means revenues and expenses. Revenue could come from sales, accounts receivable, refunds, and any settlements. Expenses could be payments to employees and suppliers, fines, fees, lawsuits, cash payments for interest, refunds to customers, etc.

Investing activities

These are less common sources of cash. Usually they are associated with buying or selling assets. Cash inflows could come from loan collection, or sales of securities (from other entities) or long-term assets. Cash outflows could come from buying fixed assets, debt or equity (from other entities) or loans.

Financing activities

These cash flows come from changes in equity and borrowing. Cash inflows here could come from a company selling its own equity or proceeds from derivatives. Cash outflows could come from paying out dividends, debt issuance costs or outstanding debt.

Cash comprises both cash in hand and demand deposit with banks.

CashFunds- According to AS-3 issued by ICAI cash funds include: Cash in hand, Demand deposits with banks and cash equivalents.

CashEquivalent: Cash equivalent are short-term highly liquid investment that are readily convertible into known amount of cash and which are subject to an insignificant risk of changes in value. Cash equivalent are held for the purpose of meeting short-term cash obligations rather than for investment or other purpose. Therefore, an investment will be known as cash equivalent only when it has a short maturity period, say three months or less from date of its acquisition. It includes: Bank overdrafts, cash credit, short-term deposits, and Marketable securities. Treasury bills, Commercial paper, Money market funds, Investment in preference shares, if are redeemable within three months can be taken as cash equivalent, if there is no risk of the failure of the company to repay the amount at maturity.

Objective of Cash Flow Statement- The objective of Cash flow statement as given in AS-3 (Revised) are as follows: Information about the cash flows of an enterprise are useful to the users of financial statements because these are the basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

This statement deals with the provision of information about the historical changes in cash and cash equivalent of enterprise by means of a cash flow statement which classified cash flows during the period from operating, investing and financing activities.

Cash Flow Analysis vs. Funds Flow Analysis

a. A cash flow statement is concerned only with the changes in cash position while funds flow analysis is concerned with changes in working capital position between two balance sheet dates.
b. Cash flow analysis is a tool of short-term financial analysis while the funds flow analysis is comparatively a long-term one.
c. Cash is part of working capital and therefore an improvement in cash position results in improvement in the funds position but not vice versa. In other words “inflow of cash” results in “inflow of funds” but inflow of funds may not necessarily result in “inflow of cash”.

d. In funds flow analysis, the changes in various current assets and current liabilities are shown in a separate statement called schedule of changes in working capital in order to ascertain the net increase or decrease in working capital. But in cash flow analysis, such changes are adjusted to funds from operations in order to ascertain cash from operations.

Format of Cash Flow Statement- A typical format of the multiple-step income statement divides the income statement into operating and non-operating sections and would contain the following components:

Operating section- Includes the revenues and expenses of the company's primary operations A. Revenue (sales). B. Cost of goods sold or service provided. C. Selling expenses. D. General and administrative expenses. E. Other operating expenses.

Non-Operating section- Income from investments, gains and losses from the sale of operating assets, interest revenue, and interest expense are reported as arising from non-operating activities. The operating section includes sales, COGS, and operating expenses, while non-operating section includes revenues, gains, expenses, and losses stemming from activities that are not part of the main activity of the business. Therefore, according to the income statement operating activities are related to the transactions and other events entering into the determination of operating profit. As its name implies, CFS is a flow statement, like the income statement. The format of CFS is grounded on the same idea – to classify activities as operating and non-operating (the latter are sub classified as investing and financing activities). Interpreting CFS requires an understanding of two relations, the relation between profit (net profit or operating profit) and cash flows from operations, the relation between the net cash flows from operating, investing, and financing activities.

Operating activities in CFSs can be treated as inflows and outflows of cash related to the transactions entering into the determination of

1) Net profit;

2) Net operating profit.

Consequently, depending on choice, net operating cash flow should:

1) Highlight the differences between operating profit and net cash flow from operating activities;
2) Highlight the differences between net profit and net cash flow from operating activities. It is worth mentioning that these two versions are based on different concepts of operating activities.

The first concept could be denominated as ‘net profit approach’ and the second one as ‘operating profit approach’. The conversion process classifies the income statement’s operating section into its major components and determines cash collections or payments for each of them. It clearly appears from the direct method of preparing CFS (especially if the so-called modified indirect method or “semi-direct” method has been used). Under the indirect method of preparing CFS the reconciliation of net profit with cash flows from operating activities is somewhat misleading because the operating activities (and therefore, the content of operating sections) on two financial statements are treated differently (and therefore, content of operating sections on the income statement and CFS is different). Despite the endless confusion about the concept of operations and about different aspects of operations, in our opinion the treatment of an item in the income statement should determine its classification in the cash flow statement. The only reconciliation of operating profit with cash flows from really operating activities provides the link between the operating sections of two financial statements.

Cash Flow Statement for the year ending…… (Direct method)

Particulars	Rs.	Rs.
a) Cash flows from Operating Activities :		
Cash receipts from customers		
Cash paid to suppliers and employees*		
Cash generated from operating activities		
Income tax paid*		
Cash flow before extraordinary items (+ or – items)		
Net cash from operating activities		
b) Cash flows from Investing Activities :		
Purchase of fixed assets*		
Sale of fixed assets		
purchase of investment (long term)*		
Sale of investment (long term)		
Interest received		
Dividend received		
Net cash from investing activities		
C- Cash flows from Financing Activities :		
Proceeds from issue of share capital		
Proceeds from long term borrowings		
Repayments of long term borrowings*		
Interest paid*		
Dividend paid*		
Net cash from financing activities		
Net increase or decrease in the cash and cash equivalents (A+B+C)		
Cash and cash equivalents at the beginning of period		
Cash and cash equivalents at the end of the period		

*amounts that are to be deducted.

Cash Flow Statement for the year ending…… (Indirect method)

Particulars	Rs.	Rs.
A- Cash flows from Operating Activities :		
Net profit before tax and extraordinary items		
Adjustment for-		
Depreciation		
Loss on sale of fixed assets		
Gain on sale of fixed assets*		
Interest paid		
Interest received*		
Dividend received*		
Operating profit before working capital changes		
Add : Decrease in current assets		
Increase in current liabilities		
Less : Increase in current assets*		
Decrease in current liabilities*		
Cash generated from operating activities		
Income tax paid*		
Cash flow before extraordinary items (+ or – items)		
Net cash from operating activities		
B- Cash flows from Investing Activities :		
Purchase of fixed assets*		
Sale of fixed assets		
purchase of investment (long term)*		
Sale of investment (long term)		
Interest received		
Dividend received		
Net cash from investing activities		
C- Cash flows from Financing Activities :		
Proceeds from issue of share capital		
Proceeds from long term borrowings		
Repayments of long term borrowings*		
Interest paid*		
Dividend paid*		
Net cash from financing activities		
Net increase or decrease in the cash and cash equivalents (A+B+C)		
Cash and cash equivalents at the beginning of period		
Cash and cash equivalents at the end of the period		

*amounts that are to be deducted.

Extraordinary items: Cash flows relating to extraordinary items such as bad debts recovered, claims received from insurance companies, winning from lottery or a law suit etc. should be disclosed separately as arising from operating, investing or financing activities. For example, the amount received from insurance company on account of loss of stock by fire, earthquake, floods etc. should be reported as cash flows from operating activities.

Note: In case of financial enterprise such as Bank or Mutual Fund Company cash outflow and cash inflow arising from the purchase and sale of securities will be treated as flows from operating activities. This is, because, purchase and sale of securities is a part of operating activity in case of financial enterprises. In addition, interest paid and interest received as well as dividends received will also be treated as cash flows from operating activities in case of financial enterprises.

Summary

A funds flow statement officially called as statement of changes in financial position, provides information about an enterprise's investing and financing activities during the accounting period. Though there are many concepts of funds, the working capital concept of funds has been used in this lesson. Flow of funds results only when there is a cross transaction i.e. only when a transaction involves a fixed asset or liability and a current asset or liability. The main sources of funds are: funds from operations, issue of shares and debentures and sale of non-current assets. The main uses of funds are repayment of long-term liabilities including redemption of preference shares and debentures, purchase of non-current assets and payment of dividends. Funds flow statement helps the financial analyst in having a more detailed analysis and understanding of changes in the distribution of sources between two balance sheet dates. In addition to funds flow statement concerns are also preparing cash flow statement which is the outcome of cash flow analysis. Cash flow analysis is based on the movement of cash and bank balances and the cash flow statement is a statement depicting changes in cash position from one period to another period.

Key words

Working Capital: working capital is that part of capital used for the purposes of day-to-day operations of a business.
Fund: fund refers to the long term capital used for financing current assets. It can be ascertained by finding the difference between current assets and current liabilities.
Flow of funds: flow refers to transactions which change the size of fund in an organisation. The flow transactions are divided into uses and sources. While the former refers to those transactions which reduce the funds, the latter increases the size of fund.
Cash: cash refers to cash and bank balances.
Cash Flow: cash flow refers to the actual movement of cash in and out of an organisation.