AS 3 – CASH FLOW STATEMENTS

CA Final Course Paper Financial Reporting
Chapter 1 Unit 4

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Contents

Applicability

For the following entities Cash Flow Statement ins mandatory.

Enterprises whose equity or debt securities are listed whether in India or outside India.

Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

Banks including co-operative banks.

Financial institutions.

Enterprises carrying on insurance business.

Applicability Cont…

All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds 50 crore. Turnover does not include 'other income'.

All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of 10 crore at any time during the accounting period.

Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Such companies are however encouraged to comply with the Standard.

Objective

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise 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.

The Standard deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

Scope

An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.

Users of an enterprise’s financial statements are interested in how the enterprise generates and uses cash and cash equivalents.

This is the case regardless of the nature of the enterprise’s activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise.

Enterprises need cash for essentially the same reasons, however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.

Benefits of Cash Flow Information

A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities.

Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises.

It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

Benefits of Cash Flow Information (contd.)

Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows.

It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

Definitions

Cash comprises cash on hand and demand deposits with banks.

Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows are inflows and outflows of cash and cash equivalents.

Definitions Cont..

Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Cash and Cash Equivalents

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes.

For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. An investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition.

Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

Cash and Cash Equivalents cont..

Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities.

Cash management includes the investment of excess cash in cash equivalents.

Presentation of a Cash Flow Statement

The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

An enterprise presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business.

Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

A single transaction may include cash flows that are classified differently. For example, when the installment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

Operating Activities

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without recourse to external sources of financing.

Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise.

They generally result from the transactions and other events that enter into the determination of net profit or loss.

Operating Activities (Contd.)

<u>Examples of Cash flows from Operating Activities</u>

- cash receipts from the sale of goods and the rendering of services
- cash receipts from royalties, fees, commissions and other revenue
- cash payments to suppliers for goods and services
- cash payments to and on behalf of employees
- cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits
- cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities and
- cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

Operating Activities (Contd.)

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

Investing Activities

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Examples of cash flows arising from investing Activities

- cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets
- cash receipts from disposal of fixed assets (including intangibles)
- cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes)

Investing Activities

cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes)

cash advances and loans made to third parties (other than advances and loans made by a financial enterprise)

cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise)

cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

Financing Activities

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise.

<u>Examples of cash flows arising from financing activities are</u>:

- cash proceeds from issuing shares or other similar instruments
- cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings and
- cash repayments of amounts borrowed.

Other Points

Reporting on Cash Flow from Operating Activities

An enterprise should report cash flows from operating activities using either:

- the **direct method**, whereby major classes of gross cash receipts and gross cash payments are disclosed; or
- the **indirect method**, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method.

Reporting on Cash Flow from Operating Activities

Under the direct method, information about major classes of gross cash receipts or cash payments may be obtained for:

- from the accounting records of the enterprise; or
- by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for:
  - i) changes during the period in inventories and operating receivables and payables
  - ii) other non-cash items and
  - iii) other items for which the cash effects are investing or financing cash flows.

Reporting on Cash Flow from Operating Activities

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

- changes during the period in inventories and operating receivables and payables
- non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses and
- all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Reporting on Cash Flows on Net basis

Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

- ***cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise*;**

Examples:

- the acceptance and repayment of demand deposits by a bank;
- funds held for customers by an investment enterprise; and
- rents collected on behalf of, and paid over to, the owners of properties.

Reporting on Cash Flows on Net basis Cont..

cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

Examples:

- principal amounts relating to credit card customers;
- the purchase and sale of investments; and
- other short-term borrowings, for example, those which have a maturity period of three months or less.

Reporting on Cash Flows on Net basis (Contd.)

Cash flows arising from each of the following activities of a financial enterprise may be reported on a net basis:

- cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date
- the placement of deposits with and withdrawal of deposits from other financial enterprises and
- cash advances and loans made to customers and the repayment of those advances and loans.

Foreign Currency Cash Flows

Cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow.

A rate that approximates the actual rate may be used if the result is substantially the same as would arise if the rates at the dates of the cash flows were used.

Foreign Currency Cash Flows cont..

The effect of changes in exchange rates on cash and cash equivalents held in a foreign currency should be reported as a separate part of the reconciliation of the changes in cash and cash equivalents during the period.

Cash flows denominated in foreign currency are reported in a manner consistent with Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates. This permits the use of an exchange rate that approximates the actual rate.

Foreign Currency Cash Flows (Contd.)

Unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period.

This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end-of period exchange rates.

Extraordinary Items

The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.

The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the enterprise.

These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items required by Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Interest and Dividends

Cash flows from interest and dividends received and paid should each be disclosed separately.

Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities.

In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities.

Interest and Dividends Cont..

Dividends paid should be classified as cash flows from financing activities.

Interest paid and interest and dividends received are usually classified as operating cash flows for a financial enterprise.

It is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are cost of obtaining financial resources or returns on investments.

Taxes on Income

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a cash flow statement.

Taxes on Income Cont..

While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions.

Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flow are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Investment in Subsidiaries, Associates and Joint Ventures

When accounting for an investment in an associate or a subsidiary or a joint venture, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee/joint venture, for example, cash flows relating to dividends and advances.

Acquisitions and Disposals of Subsidiaries and Other Business Units

The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately and classified as investing activities.

An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:

- the total purchase or disposal consideration; and
- the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

The separate presentation of the cash flow effects of acquisitions and disposals of subsidiaries and other business units as single line items helps to distinguish those cash flows from other cash flows. The cash flow effects of disposals are not deducted from those of acquisitions.

Non- Cash Transactions

Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an enterprise. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period.

Examples of non-cash transactions are:

- the acquisition of assets by assuming directly related liabilities
- the acquisition of an enterprise by means of issue of shares and
- the conversion of debt to equity.

Components of Cash and Cash Equivalents

An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

In view of the variety of cash management practices, an enterprise discloses the policy which it adopts in determining the composition of cash and cash equivalents.

The effect of any change in the policy for determining components of cash and cash equivalents is reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Other Disclosures

An enterprise should disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by it.

There are various circumstances in which cash and cash equivalent balances held by an enterprise are not available for use by it.

Examples include cash and cash equivalent balances held by a branch of the enterprise that operates in a country where exchange controls or other legal restrictions apply as a result of which the balances are not available for use by the enterprise

Additional information may be relevant to users in understanding the financial position and liquidity of an enterprise.

Other Disclosures (Contd.)

Disclosure of this information, together with a commentary by management, is encouraged and may include:

- the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and
- the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity.

The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the enterprise is investing adequately in the maintenance of its operating capacity.

An enterprise that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

CASE STUDIES

Case Study 1

Mr. Y, was preparing cash flow statement of A2Z Limited for the year ended March 31, 2013. The company had received a refund of ` 22 Lakhs from Income Tax department pertaining to Financial Year 2011-12.

Mr. Y is confused, whether this will form part of Operating Cash Flows. Can you please help

Case Study 1

The amount received from the Income Tax department received towards refund will form part of operating cash flows.

As per para 12, “Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss.”

Hence, the amount of refund received shall be treated as cash flows from operating activities.

Case Study 2

Zeta Limited, had disposed off one of the bagging plant for during the financial year and had a profit on the sale amounting to ` 56 Lakhs.

The Accounts Officer says that as the profit on sale was considered under the cash flows from operating activities, the entire amount realised shall be also be considered as Cash flows from operating activities.

Is his contention right ?

Case Study 2

No. The Accounts Officer’s contention is not correct.

As per para 13, “Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.”

Hence the amount realised from sale of fixed assets shall be considered as cash flows from Investing activities.

Case Study 3

Munificence Ltd, holds preference shares which are redeemable within six months from the year end. The Finance Head is of the opinion that since the preferences shares are redeemable within six months they can be treated as cash and cash equivalent.

Is he correct in doing so ?

Case Study 3

No. The contention of the Finance Head is not correct.

As per para 6, “Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents.”

As the preference shares are not readily convertible to a known amount of cash, the same shall not be considered as cash equivalent

Case Study 4

MXZ Ltd, has acquired 40% shares in ABC Ltd, from Mr.Y. MXZ Ltd issued shares for the said acquisition.

Should this transaction be reflected in the Cash Flow Statement of MXZ Ltd?

Case Study 4

No. The transaction will not be reflected in the Cash Flow Statement of MXZ Limited as it is a non – cash transaction.

As per para 41, “Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an enterprise. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period.”

Lesson Summary