TOPIC 31

INDAS - 7

STATEMENT OF CASH FLOW

Index

Quote:- Life does not have to be perfect to be wonderful

The statement of cash flows is THE ONLY statement ignoring an accrual basis and based on a CASH basis.

All other financial statements follow an accrual principle and it means that we have lots of non-cash transactions in our financial statements that we need to eliminate for cash flows.

Why INDAS - 7?

The statement of cash flows shows the **ability of any company to generate cash.**

But in reality, many investors explore the statement of cash **flows right after looking to profit figure,** because they sometimes feel that the profit could be manipulated by some non-cash transactions, such as various provisions, fair value adjustments, etc.

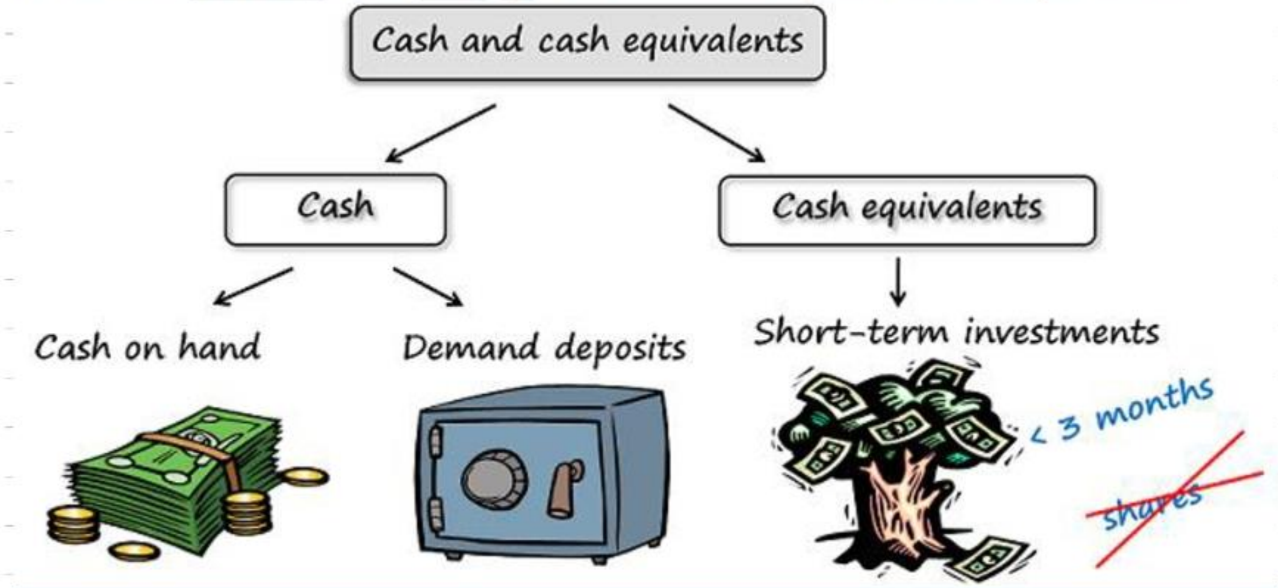
However, cash is cash and the statement of cash flows not only shows you **HOW MUCH CASH** the company generated over the year, but also **WHERE** the cash was generated:

- Did the company increase their sales and generated cash by operating activities?
- Did the company sell some of its property and generated cash by investing activities?
- Or did the company take new loans and generated cash by financing activities?

So, looking to where the cash was generated and spent is as important as assessing the liquidity ratio, profitability ratio, and other financial indicators.

What comprises cash and cash equivalents?

The statement of cash flows shows you the movements in cash and cash equivalents.



Cash comprises cash on hand (e.g. petty cash) and demand deposits (e.g. bank accounts).

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

Here, the investment with short maturity (up to 3 months) would qualify for cash equivalent – for example, state treasury note. However, most shares and other equity instruments are excluded from cash equivalents.

Please note that the movements between cash and cash equivalents is a **part of cash management and are not shown** in the operating, financing or investing part of the statement of cash flows. So if your company buys the state treasury bill with short maturity date, then this movement is not shown (it appears as the cash and cash equivalents have not moved at all).

It has been clarified, that there should not be a difference in the amount of cash and cash equivalent as per Ind AS 1 and as per Ind AS 7.

However, as per Ind AS 7 "where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents.

A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn."

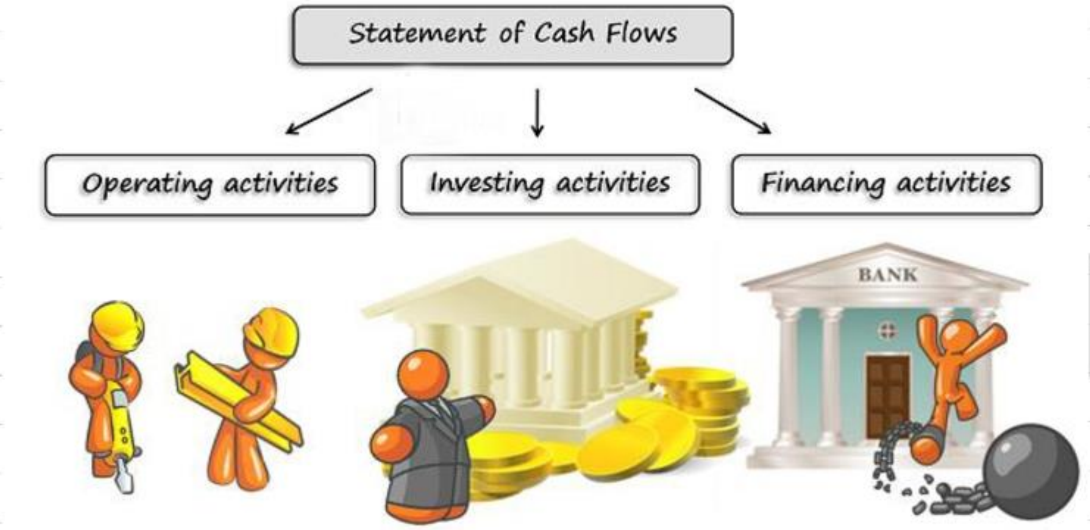
Although Ind AS 7 permits bank overdrafts to be included as cash and cash equivalent, for the purpose of presentation in the balance sheet, it would not be appropriate to include bank overdraft in the line item cash and cash equivalents unless the netting off conditions as given in paragraph 42 of Ind AS 32, Financial Instruments: Presentation are complied with.

Bank overdraft, in the balance sheet, will be included within financial liabilities. Just because the bank overdraft is included in cash and cash equivalents for the purpose of Ind AS 7, does not mean that the same should be netted off against the cash and cash equivalent balance in the balance sheet.

Instead Ind AS 7 requires a disclosure of the components of cash and cash equivalent and a reconciliation of amounts presented in the cash flow statements.

How the Statement of Cash Flows shall be Presented?

INDAS - 7 says that the statement of cash flows shall report cash flows during the period **classified by operating, investing and financing activities.**



In the notes to the financial statements, an entity shall disclose the **components of cash and cash equivalents.**

OPERATING ACTIVITIES

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

This part is probably **the most important**, because it shows the ability of the company to generate cash by its own activities, rather than by external financing or making investments.

Cash flows from operating activities result from the primary revenue-generating activities of each company and therefore, there might be differences between different entities.
For example, manufacturing company would report advance given for the acquisition of PPE as investing activity, but the bank would report similar advance as an operating activity based on its specific purpose.
However, operating activities generally result from profit making activities and the examples are:

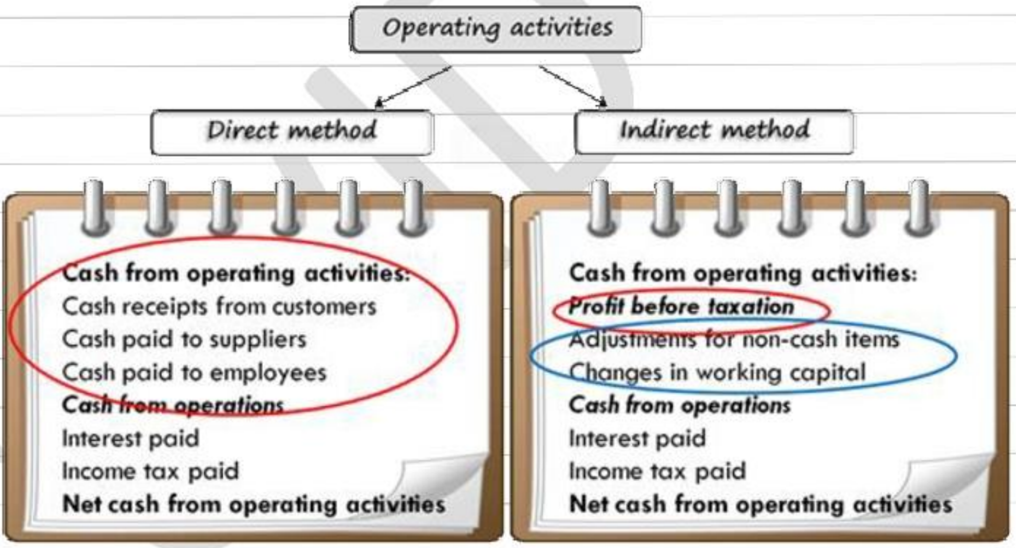
- Cash receipts from the sale of goods and the rendering of services;
- Cash receipts from royalties, fees, commissions and other revenue;
- Cash payments to suppliers for goods and services;
- Cash payments to and on behalf of employees;

- Cash receipts and cash payments of an insurance entity 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 from contracts held for dealing or trading purposes.

Direct and Indirect Method

A company may select from **2 methods** of reporting cash flows from operating activities:

1. **Direct method:** here, you need to disclose major classes of gross cash receipts and gross cash payments; or
2. **Indirect method**: here, you start with the profit or loss before tax and then you adjust it for the effect of:
    - o Working capital changes over the period (inventories, operating receivables, payables);
    - o Non-cash items (depreciation, unrealized foreign exchange gains or losses, etc.);
    - o Items associated with investing or financing activities.



Direct method provides more understandable information not disclosed under indirect method. However, in reality, indirect method is far more preferred because it's easier to get the information based on your accounting records. (in most cases).

INVESTING ACTIVITIES

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

Examples *of cash flows classified in investing activities are:*

- *Cash payments to acquire property, plant and equipment, intangibles and other long-term assets (including capitalized development costs and self-constructed PPE);*
- *Cash receipts from sales of PPE, intangibles and other long-term assets;*
- *Cash payments to acquire and cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (but not for trading or dealing purposes);*
- *Cash advances and loans made to other parties, and cash receipts from their repayment (other than advances and loans made by a financial institution – these would go to operating part);*
- *Cash payments for and cash receipts from various derivative contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities.*

FINANCING ACTIVITIES

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Examples of cash flows arising from financing activities are:

- *Cash proceeds from issuing shares or other equity instruments;*
- *Cash payments to owners to acquire or redeem the entity's shares;*
- *Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;*
- *Cash repayments of amounts borrowed; and*
- *Cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.*

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Reporting cash flows from Investing and Financing Activities

Cash flows from investing and financing activities shall always be ***reported GROSS****, so no netting off.*

Example

If in the year 20X1-20X2, some land is purchased for Rs. 2.5 crores and another land is sold for Rs. 3.5 crores then while presenting the information, entity shall show separately outflow of Rs. 2.5 crores and inflow of Rs. 3.5 crores.

However, INDAS - 7 gives you ***2 exceptions*** *where you actually can present net:*

- *Cash receipts and payments* ***on behalf of customers*** *when the cash flows reflect the activities of the customer rather than those of the entity. For example, some real estate company can collect rents from tenants and pay them over to the property owners.*
- *Cash receipts and payments for* ***items in which the turnover is quick, the amounts are large, and the maturities are short****. For example, changes in principal amounts relating to credit card customers.*

Also, financial institutions can report certain transactions on the net basis.

OTHER ISSUES

Foreign currency

When there are foreign currency cash flows, then you need to translate them to your functional currency by applying the ***exchange rate at the date of the cash flow.***

However, be careful at the closing, because ***unrealized year-end foreign exchange gains or losses are NOT cash flows.*** *If they relate to your cash or cash equivalents, then you should present these amounts in the separate line in the final reconciliation.*

Interest and Dividends

	Financing Company	Other Company
Interest Paid	Operating Activities	Financing Activities
Interest and Dividend Received	Operating Activities	Investing Activities
Dividends Paid	Financing Activities	Financing Activities

Taxes on Income

Basically, cash flows arising from income taxes are classified as cash flows from operating activities.

But if you can specifically identify these taxes with financing or investing activities, then you should report your cash flows from taxes in these parts.

Investments

When you hold some investments in subsidiaries, associates and joint venture, then reporting cash flows to and from these investments really **depends on the accounting method** you use. When you apply equity or cost method, then you should include only the cash flows between yourself and the investee into the cash flow statement (dividends or advances).

Changes in Ownerships Interests in Subsidiaries and Other Businesses

- The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.

- Cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control shall be classified as cash flows from financing activities, unless the subsidiary is held by an investment entity and is required to be measured at fair value through profit or loss.

Properties Built For Let Out

Cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

Operations of Financial Companies and Banks

An entity 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 institutions are usually classified as operating activities since they relate to the main revenue-producing activity of that entity.

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Q444. (ICAI MODULE)

Z Ltd. has no foreign currency cash flow for the year 2017. It holds some deposit in a bank in the USA. The balances as on 31.12.2017 and 31.12.2018 were US $ 100,000 and US $ 102,000 respectively. The exchange rate on December 31, 2017 was US $ 1 = Rs. 45. The same on 31.12.2018 was US $ 1 = Rs. 50. The increase in the balance was on account of interest credited on 31.12.2018. Thus, the deposit was reported at Rs. 45,00,000 in the balance sheet as on December 31, 2017. It was reported at Rs. 51,00,000 in the balance sheet as on 31.12.2018. How these transactions should be presented in cash flow for the year ended 31.12.2018 as per Ind AS 7?

Solution:

The profit and loss account was credited by Rs. 1,00,000 (US$ 2000 × Rs. 50) towards interest income. It was credited by the exchange difference of US$ 100,000 × (Rs. 50 – Rs. 45) that is, Rs. 500,000. In preparing the cash flow statement, Rs. 500,000, the exchange difference, should be deducted from the 'net profit before taxes, and extraordinary item'. However, in order to reconcile the opening balance of the cash and cash equivalents with its closing balance, the exchange difference Rs. 500,000, should be added to the opening balance in note to cash flow statement.

Cash flows arising from transactions in a foreign currency shall be recorded in Z Ltd.'s functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.

Student Notes:-

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Student Notes:-

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