CFS—Some Missing Blocks

The changing economic conditions have brought remarkable changes in cash management activities that also affect the rules and styles of preparation and presentation of financial statements as well as techniques used in financial analysis. Protecting the interests of the investors has become the primary objectives of policymakers. Cash Flow Statements (CFS) have come a long way from a small financial analytical tool to being a part of financial statements. They are being considered the best of the techniques used to assess the short term liquidity and enterprise ability to generate cash by depicting application and uses of cash under Operating, Investing and Financing activities. The article tries to discuss a few observations which limit the usefulness and are generally made in preparing these crucial statements and at the same time provide suggestions to improve those weaknesses so that CFS can be made more transparent and investor friendly.

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Introduction

The statement of cash flows is a very popular and commonly used analytical tool. The usefulness of cash flow can be known from the fact that even the statute has made it mandatory for many companies to publish their Cash Flow Statement (CFS) as a part of annual financial statements. And the statutory auditors are also made responsible for expressing audit opinion on the true and fair view of these statements. CFS is useful in determining the short-term viability of a company and is intended to provide information on a

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firm's liquidity and solvency and its ability to change cash flows in future circumstances, provide additional information for evaluating changes in assets, liabilities and equity and also indicate the amount, timing and probability of future cash flows.

The CFS first became popular when in 1987 the FASB adopted the Statement of Financial Accounting Standard (SFAS) 95 entitled "Statement of Cash Flows." This standard mandated the Statement of Cash Flow as a required subset of a company's financial statements if the company's financial statements are audited. In India, Accounting Standard (AS) 3, Cash Flow Statements, was made mandatory in respect of accounting periods commencing on or after 1.4.2001 for a select group of companies.

For financial statement preparers, Cash Flow Statement is one of the easiest statements to prepare and comply with. A simple AS, there are not many complicated guidelines, rules and disclosure requirements in it. The current format and manner of presentation and disclosure of CFS has been widely accepted as ideal and is quite the same across the globe. Even the new Companies Act 2013 has not prescribed any format or method of preparing CFS. There are not many differences in requirements of preparation and policies to be adopted among Indian AS-3, IAS-7 and even US GAAP. The basic format of CFS is also quite old.

However, the recent changes in economic and statutory framework along with increasing questions on the reliability of financial statements have created a need to review the styles of preparations of these statements. The following observations are generally seen in practice and need a special attention to increase the reliability of CFS and provide a better and fair view of the financial management of an entity:

Direct vs. Indirect Method

The AS provides an option to prepare CFS either under Direct or Indirect method. All the companies use indirect method for presentation. This is mostly because not only is this method easier to adopt but also since the Listing Agreement requires so. Amendment to Clause 32 says *"The Cash Flow Statement will be prepared in accordance with the Accounting Standard on Cash Flow Statement (AS-3) issued by the Institute of Chartered Accountants of India, and the Cash Flow Statement shall be presented only under the Indirect Method as given in AS-3"*.

The clause 19 of Ind AS 7 reads *"Entities are encouraged to report cash flows from operating activities using the direct method."* Thus we find that there is a contrast in recommendations made by AS and SEBI regulations and though Direct method is considered superior in providing more useful information, it is hardly followed.

But this takes away a major advantage of preparation of CFS. Research shows that direct method gives more useful information to an investor in terms of estimating future cash flows and earning potential. Some cash flow items, such as collections from customers, are difficult to estimate in the indirect method. Moreover, the line items included in the operating activities prepared under indirect method are quite the same as those already included in the income statement and hence there is a mere repetition. Even the IASC considers the indirect method less clear to users of financial statements. Thus, entities must be encouraged to use the direct method.

Current and non-Current Classification

The Revised Schedule VI has revolutionised the way we present our financial statements. Now we have moved towards presenting our financial statements by segregating the entire major heads into current and non-current. This gives a better picture of the short term and long term position of the assets and liabilities of an entity.

In a CFS, under the investing and financing activities, we find that all current and non-current cash flows are bundled up together and usually in no particular order. Here too, if the activities are sub-grouped into current and non-current on

the same lines as balance sheet, then CFS will complement rest of the financial statements and will be easier to compare and read. Their usefulness can be enhanced by grouping them according to common characteristics. For e.g.

Cash flow from Investing Activities:
- From non-current:
- From current:

Cash flow from Financing Activities:
- From non-current:
- From current:

This will give more information to investors in relation to inflow and outflow of cash in long term and short term investing and financing activities. For e.g., an investor can know how much of the long term finances have increased in relation to long term investing activities and whether the same has been utilised to finance short term/current obligations/ benefits.

Cash and Cash Equivalents-Foreign currency figures

There has already been much debate on the definition of cash and cash equivalent and some principles have been formulated keeping in mind general environment conditions. This head includes companies' foreign currency current accounts in reporting currency terms. These amounts are translated in accordance with AS11 by using the closing rate on the date of preparation of financial statements. With highly fluctuating currency rates, these amounts shown by the statements can only be misleading in terms of value of cash. Here, the investor has no knowledge of the extent of companies' exposure to foreign currency risks *viz*. cash-in-hand. This problem gets aggravated in consolidated CFS which include cash in hand of foreign subsidiaries. CFS is prepared to show short term viability and liquidity of a company and if cash and cash equivalent figures are not clearly understandable, then a question of reliability occurs.

The cash flow statement is prepared to eliminate allocations which might be derived from different accounting methods. Cash basis is one of the bases of accounting that recognises transactions and other events only when cash is received or paid i.e. reckoning the transactions on cash basis only. However, that may not be true with CFS especially when the net profit shown is itself derived from accrual basis of accounting.

An extra disclosure requirement of showing foreign currency figures in the relevant currency in the footnote can serve the purpose as this will inform the investors about the extent of foreign currency risk the company holds and in which currency the company is exposed maximum to. This can be done in the following way:

Details of foreign currency included in cash and cash equivalents:

	Foreign Currency units	*Rupee Equivalent*
Dollars		
Euro……..		

A better investment judgement can be made if an investor knows the exposure and dependence of company on weaker or stronger currency. For e.g. if an entity holds huge cash in dollar terms and in end March, the rupee grows weaker against dollar then the cash amount will show inflated figures. Here, if in the near future rupee recovers, then the investor can assess the effects only if he knows the amount of dollars included in cash.

Gross vs. Net Basis

The Rule 22 of AS requires that the Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

(a) Cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity; and

(b) Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

This means that except for the activities covered in Rule 22, all the figures have to be shown on gross basis. It is observed that this rule is frequently violated and companies show many of the other heads also on net basis ignoring the rules. The case may not be taken much seriously but this can conceal useful information from an investor and probability of material undisclosed adjustments to these figures is always there. Therefore, it should be ensured that the grossing of items is strictly followed so that quantity of inflow and outflow of cash can be easily ascertained. For e.g., proceeds from short term borrowings on the pretext of point (b). However, the word 'and' is clearly stated and only those receipts and payments should be netted which satisfy all the three conditions *viz*. quick turnover, large amounts

and short maturities. Similarly, it is observed that tax payments, profit/(loss) on assets sold and discarded, etc. are also netted.

Cash vs. Accrual Basis

The cash flow statement is prepared to eliminate allocations which might be derived from different accounting methods. Cash basis is one of the bases of accounting that recognises transactions and other events only when cash is received or paid i.e. reckoning the transactions on cash basis only. However, that may not be true with CFS especially when the net profit shown is itself derived from accrual basis of accounting. Undoubtedly, we try to eliminate the effects of non-cash transactions by adding them back to profits but this is not fully achieved as many expenses which contain both cash and non-cash items are not commonly adjusted as is quite evident from the study of CFS of different companies.

For e.g., interest paid and received, which is prepared using accrual basis of accounting, contains interest accrued/outstanding figures also. We may be able to eliminate the effect it has on total cash flow and reconcile the CFS but the actual cash flow figures are different from that shown under the particular head. This problem gets again aggravated when foreign currency figures are involved as the actual flow on the date of transaction may be completely different from that shown to have been already made in CFS.

The inherent characteristics of the source, the financial statements is accrual system of accounting. And thus cash flow statements compiled from accrual basis of financial statements of reporting entities fail to present true liquidity and revenue generating potential. Thus, clear cut guidelines must be laid down with respect to calculations of these figures to be shown under CFS. It will otherwise be difficult for the reader of these statements to know the correct position.

Incomplete Information

Cash flow statements are often blamed for giving incomplete information and misguiding a common reader who has little knowledge about the technical aspects and rules for preparation. For e.g. if a company disposes off/acquires any undertaking, a part payment for which is made in consideration other than cash, then the cash flow statement will include only the amount paid in cash and the rest will be left out, creating a situation of doubt in the reader's mind and giving him incomplete information.

Cash flow statement serves as an important financial tool and has the ability to provide information to investors which is generally not provided elsewhere in the financial statement and hence is an important investment analysis tool. It is a window of assessing cash management of an entity. However, the above mentioned shortcomings are reducing the validity of this statement.

The disclosure requirements in such cases are important which are generally ignored. And even if made, are made in such a way that the overall objective of the Cash Flow Statement of enabling investors to evaluate the ability of the company to generate cash flows and to understand the timing and certainty thereof are not achieved. Under IAS 7 non-cash investing and financing activities are disclosed in footnotes to the financial statements and Under US General Accepted Accounting Principles (GAAP), non-cash activities may be disclosed in a footnote or within the cash flow statement itself. There are few such requirements in Indian AS also.

Thus, it is observed that though the rules related to disclosure requirements and netting off items are highly violated, not a single audit opinion on the financial statements of the companies include a qualification pointing to non-compliance with the standards on cash flow statements. These should be strictly followed and properly disclosed so that the reader can easily understand and not get misdirected.

Concluding Remarks

Cash Flow Statements serve as an important financial tool and has the ability to provide information to investors which is generally not provided elsewhere in the financial statement and hence is an important investment analysis tool. It is a window of assessing the cash management of an entity. However, the above mentioned shortcomings are reducing the validity of this statement. It is many times observed that the lack of disclosure requirements and their strict implementation along with paucity of local research on the subject is taking away many of the benefits it can otherwise provide. Hence, steps need to be taken to ensure better readability of the statements. ■