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Implications of Indian Accounting Standard (Ind AS – 7): Statement of Cash Flows under Financial Reporting

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Abstract

The statement of cash flows contains important information that is often the foundation by which users evaluate performance. The diversity in how cash flows are reported reduces the comparability of cash flows and results in users needing to make adjustments when performing relative analyses. Credit rating agencies, investors, and analysts utilize cash flow information when developing valuation models. The transparency of historical cash flow information, including cash inflows and outflows from operating activities, can promote a better understanding of a company's relative performance and enhance the predictive value of its cash flow results. Companies should consider whether their financial statements provide enough disclosure of how they report cash flows and the primary drivers and material factors giving rise to cash flow results. This paper describes the disclosure requirement, importance of cash flow statement, enhancing the usefulness of cash flow and reporting of cash flow statement.

Keywords: Implication of cash flow, disclosure requirement, reporting of cash flow

Introduction

Implication of Mandatory Status

Where the statute governing the enterprise does not require compliance with the accounting standards, e.g. a partnership firm, the mandatory status of an accounting standard implies that, in discharging their attest functions, the members of the Institute are required to examine whether the financial statements are prepared in compliance with the applicable accounting standards. In the event of any deviation from the accounting standards, they have the duty to make adequate disclosures in their reports so that the users of financial statements may be aware of such deviations. It should nevertheless be noted that responsibility for the preparation of financial statements and for making adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements. Section 129 (1) of the Companies Act, 2013 requires companies to present their financial statements in accordance with the accounting standards notified under Section 133 of the Companies Act, 2013. Also, the auditor is required by section143 (3) (e) to report whether, in his opinion, the financial statements of the company audited, comply with the accounting standards referred to in section133 of the Companies Act, 2013. Where the financial statements of a company do not comply with the accounting standards, the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviations as per Section 129 (5) of the Companies Act, 2013. Provided also that the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose-

- In the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;
- In the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;
- In the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;
- In the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

Objective

Information about the cash flows of an entity is useful in providing 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 utilize those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation. The objective of this Standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from Operating, Investing and Financing activities.

Scope

An entity shall prepare a statement of cash flows in accordance with the requirements of this Standard and shall present it as an integral part of its financial statements for each period for which financial statements are presented. Users of an entity's financial statements are interested in how the entity generates and uses cash and cash equivalents this is the case regardless of the nature of the entity's activities and irrespective of whether cash can be viewed as the product of the entity, as may be the case with a financial institution. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors. Accordingly, this Standard requires all entities to present a statement of cash flows.

The Importance of the Statement of Cash Flows

The statement of cash flows is regarded by many users of the financial statements in a number of industries as the most important financial statement. When combined with other financial information, the statement of cash flows can be a useful tool to analyze key relationships in the financial statements, evaluate past performance, and predict future performance. Further, because the income statement uses the accrual method, the statement of cash flows is needed to show cash generated and spent.

The statement of cash flows can reveal circumstances in which earnings growth does not correlate with operating cash flow growth. This may alert users to the need to look closely at the drivers of earnings or may be an indicator of other lifecycle considerations for emerging or declining businesses. The statement also facilitates a user's assessment of a company's ability to generate cash from core business activities, which is often a key variable when valuing a business and assessing its ability to repay debt, make capital expenditures, and pay dividends.

Credit rating agencies, investors, and analysts utilize cash flow information when developing valuation models. The transparency of historical cash flow information, including cash inflows and outflows from operating activities, can promote a better understanding of a company's relative performance and enhance the predictive value of its cash flow results.

Differences in Cash Flow Reporting

Inappropriate classification and treatment of non-cash items in the statement of cash flows can result in differences and, when identified, area frequent cause of restatements. But companies also report cash flows differently based on a reasonable interpretation of the principles-based framework or differences in their facts and circumstances. These factors contribute to reduced comparability of cash flows among companies. Examples of diversity include:

- The acquisition of similar assets is reported as an operating or investing activity depending on whether the assets are considered inventory to be utilized in the generation of revenue (operating) or a productive asset (investing).
- Capitalized interest is reported within investing activities as part of capital expenditures when the expenditure initially occurs and recognized as depreciation expense when the asset is consumed. Operating cash flows of a company that capitalizes significant amounts of interest may need to be adjusted to reflect its true debt service costs.
- There is no prescribed method of presenting cash flows of a discontinued operation. As such, some companies do not report those cash flows in the statement of cash flows; others specifically identify and disclose them in the statement of cash flows in total for each category.
- Dividends that represent a return on capital are classified as operating activities while dividends that are a return of capital are classified as investing activities.
- Insurance proceeds may be reported as either operating or investing activities depending on whether the insured loss related to an operating activity or a productive asset.

Enhancing the usefulness of Cash Flow Information

There are several actions companies can considered to increase the usefulness, transparency, and predictive value of a company's cash flow information.

- Enhance liquidity disclosures by analyzing meaningful cash flow metrics. Provide guidance to help communicate management's view of future cash flow prospects.
- Enhance the footnote disclosure of the basis for presenting items in the cash flow statement, identifying where and how significant and unusual transactions are reflected in the statement.
- Enhance disclosure of the drivers of cash inflows and outflows from period to period, including describing in Management's Discussion and Analysis the primary drivers of cash flows such that a user can evaluate the predictive evaluated of historical cash flows. For example, what caused inventory to increase and what are management's future expectations? Understanding the reasons for changes in line items comprising cash flows from operations could help users evaluate whether earnings growth will correlate with future cash growth based on past performance.
- Enhance the presentation and discussion of the drivers of cash flows on an interim basis. This could include providing expanded cash flows from operating activities similar to annual presentations—rather than the abbreviated presentation permitted under SEC regulations.

Benefits of Cash Flow Information

A statement of cash flows, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an entity, 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 entity 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 entities. It also enhances the comparability of the reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for the same transactions and events.

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.

Classification of Cash Flows Statement

An entity 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 entity and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

Operating activities

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities 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. Some transactions, such as the sale of an item of plant, may give rise to a gain or loss that is included in recognized profit or loss. The cash flows relating to such transactions are cash flows from investing activities. However, cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale as described in paragraph 68-A of Ind AS-16, Property, Plant and Equipment, are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

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.

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. Only expenditures that result in a recognized asset in the balance sheet are eligible for classification as investing activities. Examples of cash flows arising from investing activities are:

- Cash payments to acquire property, plant and equipment, intangibles and other long –term assets. These payments include those relating to capitalized development costs and self-constructed property, plant and equipment;
- Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;
- Cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);
- Cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to b cash equivalents and those held for dealing or trading purposes);
- Cash advances and loans made to other parties (other than advances and loansmade by a financial institution);
- Cash receipts from the repayment of advances and loans made to other parties(other than advances and loans of a financial institution);
- 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. When a contract is accounted for as a hedge of an identifiable position the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

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 capital to 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.

Reporting Requirement

An entity shall 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 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.

Entities are encouraged to report cash flows from operating activities using the direct method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

a) From the accounting records of the entity; or
b) By adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) 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

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

a) Changes during the period in inventories and operating receivables and payables;
b) Non-Cash items such as depreciation, provisions, deferred taxes, unrealized foreign currency gains and losses, and undistributed profits of associates; and
c) 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 revenues and expenses disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Conclusion

Companies should consider whether their financial statements provide enough disclosure and discussion of the primary drivers and material factors giving rise to their cash flow results. Enhanced disclosure may help users of the financial statements better understand differences in relative cash flow performance and the predictive value of a company's cash flows. Companies that increase the transparency of their cash flows thus may improve user's understanding of their business. This in turn may benefit companies in the form of greater access to the capital markets and a lower cost of capital.

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