Cash Flow Statement

Meaning of Cash Flow Statement:

A cash flow statement is a statement of changes in the financial position of a firm on cash basis.

It reveals the net effects of all business transactions of a firm during a period on cash and explains the reasons of changes in cash position between two balance sheet dates.

It shows the various sources (i.e., inflows) and applications (i.e., outflows) of cash during a particular period and their net impact on the cash balance.

According to Khan and Jain:

"Cash Flow statements are statements of changes in financial position prepared on the basis of funds defined as cash or cash equivalents."

The Institute of Cost and Works Accountants of India defines Cash Flow statement as **"a statement setting out the flow of cash under distinct heads of sources of funds and their utilisation to determine the requirements of cash during the given period and to prepare for its adequate provision."**

Thus, a cash flow statement is a statement which provides a detailed explanation for the changes in a firm's cash balance during a particular period by indicating the firm's sources and uses of cash and, ultimately, net impact on cash balance during that period.

Features of Cash Flow Statement:

The features or characteristics of Cash Flow Statement may be summarised in the following way:

1. It is a periodical statement as it covers a particular period of time, say, month or year.

2. It shows movement of cash in between two balance sheet dates.

3. It establishes the relationship between net profit and changes in cash position of the firm.

4. It does not involve matching of cost against revenue.

5. It shows the sources and application of funds during a particular period of time.

6. It records the changes in fixed assets as well as current assets.

7. A projected cash flow statement is referred to as cash budget.

8. It is an indicator of cash earning capacity of the firm.

9. It reflects clearly how financial position of a firm changes over a period of time due to its operating activities, investing activities and financing activities.

Objectives of Cash Flow Statement:

Cash Flow Statement is prepared to fulfill some objectives.

Some of the main objectives of Cash Flow Statement are:

1. It shows the cash earning capacity of the firm.

2. It indicates different sources from which cash been collected and various purposes for which cash has been utilised during the year.

3. It classifies cash flows during the period from operating, investing and financing activities.

4. It gives answers to various perplexing questions often encountered by management, such as why the firm is unable to pay dividend instead of making enough profit? Why is there huge idle cash balance in spite of loss suffered? Where have the proceeds of sale of fixed assets gone? etc.

5. It helps the management in cash planning and control so that there are no shortage or surplus of cash at any point of time.

6. It evaluates the ability of the firm to meet obligations such as loan repayment, dividends, taxes etc.

7. A prospective investor consults the cash flow statement to ensure that his investment gets regular returns in future.

8. It discloses the reasons for differences among net income, cash receipts and cash payments.

9. It helps the management in taking capital budgeting decisions more scientifically. 10. It ensures optimum use of funds for the maximum benefit of the enterprise.

Utility or Importance of Cash Flow Statement:

Cash Flow Statement is useful for short-term planning and control of cash. A business entity needs sufficient amount of cash to meet its various obligations in the near future such as payment for purchase of fixed assets, payment of debts, operating expenses of the business etc.

It helps the financial manager to make a cash flow projection for the immediate future taking the data relating to cash inflows and cash outflows from past records. As such, it becomes easy for him to know the cash position which may either result in a surplus or a deficit one. Thus, cash flow statement is another important tool of financial analysis for the management.

Its main advantages are:

1. Evaluation of Cash Position:

It is very helpful in understanding the cash position of a firm. Since cash is the basis for carrying on business operations smoothly, the cash flow statement is very useful in evaluating the current cash position of the business.

2. Planning and Control:

A projected cash flow statement enables the management to plan and coordinate the financial operations properly. The financial manager can know how much cash is needed, from where it will be derived, how much can be generated internally, and how much could be obtained from outside.

3. Performance Evaluation:

A comparison of actual cash flow statement with the projected cash flow statement will disclose the failure or success of the management in managing cash resources. Deviations will indicate the need for corrective actions.

4. Framing Long-term Planning:

The projected cash flow statement helps financial manager in exploring the possibility of repayment of long-term debts which depends upon the availability of cash.

5. Capital Budgeting Decision:

A projected cash flow statement also helps the management in taking capital budgeting decisions.

6. Liquidity Position:

Liquidity position of a firm refers to its ability to meet short-term obligations such as payment of wages and other operating expenses etc. From cash flow statement the financial manager is able to understand how well the firm is meeting these obligations.

At the same time the ability of the firm in cash earning can be known from cash flow statement. As a matter of fact, a firm's profitability is ultimately dependent upon its cash earning capacity.

7. Answers to Different Questions:

Cash flow statement is able to explain some questions often encountered by the financial manager such as, why is the firm not able to pay dividend in spite of making huge profit? Why there is huge cash balance in spite of loss etc.

Limitations of Cash Flow Statement:

Cash Flow Statement is, no doubt, an important tool of financial analysis which discloses the complete story of cash management. The increase in—or decrease of—cash and reasons thereof, can be known, However, it has its own limitation.

These limitations are:

1. Since cash flow statement does not consider non-cash items, it cannot reveal the actual net income of the business.

2. Cash flow statement cannot replace fund flow statement or income statement. Each of them has a separate function to perform which cannot be done by the cash flow statement.

3. The cash balance as disclosed by the projected cash flow statement may not represent the real liquid position of the business since it can be easily influenced by the managerial decisions, by making certain payments in advance or by post ponding payments.

4. It cannot be used for the purpose of comparison over a period of time. A company is not better off in the current year than the previous year because its cash flow has increased.

5. It is not helpful in measuring the economic efficiency in certain cases e.g., public utility service where generally heavy capital expenditure is involved.

In spite of these limitations, it can be said that cash flow statement is a useful supplementary instrument. It helps management in knowing the amount of capital blocked 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.