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## **Unit 3 □ Cash Flow Accounting**

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### **3.0 Cash Flow Accounting—Its Rationale**

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As Lawson has emphatically remarked, “Cash flow accounting (CFA) constitutes the analytical framework for linking past, present and prospective financial performance. It is therefore a vehicle which may be used to disclose the past development of the finances of business. Alternatively, it may be used as a system for disclosing the determinants of the true return shareholders are likely to receive in the future. Cash flow accounting may therefore also be regarded as an aid to investor decision-making.”

From this it is crystal clear that CFA at present has a vital role to play. The question that needs to be examined is whether the present accrual-allocation based historical cost accounting is playing a useful role in assisting decision-making. Many studies have been conducted on this aspect and the general opinion of the studies is that historical cost accounting is not really helpful in investment, credit and similar other decisions. Here lies the importance of CFA which is the most objectively prepared allocation-free accounting. It is not affected by how reference flows are partitioned between periods. CFA, is an objective basis that takes care of both liquidity and profitability of a firm. It is also claimed by Hicks that CFA goes beyond accruals accounting to recognise all other future real cash flows, including the current value accounting concepts of future exit values for an asset and future replacement value to replace the asset. The CFA has been advocated particularly by Lee and Lawson of UK. In recent years this is being strongly supported by the accountants and economists due to the following reasons :

1. CFA, by providing the total estimated cash available to the company in future from all sources, encourages the origination of capital expenditure proposals in the company to make optimal use of the available cash.

2. Financial reports prepared on cash flow basis would provide capital expenditure decision-maker with numbers that can be used for projecting cash flows.

3. The future dividend stream can be easily forecasted from the cash flow statements (CFS). The shareholders thus will be in a position to take decision whether to sell off, or hold or further acquire the shares of firm.

4. The amount of internal cash available for financing the projects or working capital gap can be easily assessed and hence the share to be financed from outside can be estimated.

5. The creditors are also interested in cash flows while advancing loans to the company to know the credit status or viability of the company to repay them in time. Conventional accounting system has been found to be inadequate in supplying the information to them.

6. Managerial accountability would be greatly improved as the managers will not be able to 'window dress' the accounts under CFA. Under conventional accounting they can easily manipulate profits with the help of subjective accrual-based accounting.

7. CFA can serve a very useful purpose in evaluating the financial adaptability of the enterprise, That means with the help of CFA, a firm gets the ability to raise new capital at necessity, repay debt at short notice, obtain cash by selling assets without disturbing continuing operations, and achieve a rapid improvement in the net cash inflows generated from operations.

8. CFA also takes care of price level variations. This thus solves the controversy regarding the superior method of incorporating the effect of inflation.

9. A better set of share prices would emerge if more specific information of expected future cash flows is given on a regular basis. CFA performs this vital role.

10. Finally, it avoids the possibility of variability and manipulations which can result in case of the allocation-based accounting.

This being the importance of CFA in modern time, it is necessary to acquire some knowledge over its concept, nature and acceptability. The next sections touch upon these themes.

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### **3.1 CFA–Meaning and Features**

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Cash flow accounting should not be confused with cash basis of accounting. It rather takes both cash basis and accrual basis into its system but completely rejects allocation as the basis. Besides cash and accrual as bases, it also takes into account the current value accounting concept for balance sheet purposes. Hicks explains CFA in the following words :

The CFA which means recording not only the cash receipts and disbursements of the period. but also the future cash flows owned to or by the firm as a result of selling or transferring title to certain goods. Both of these are real cash flows. To reject them would be ridiculous, particularly since the ‘name of the game’ in decision-making is future cash flows, and accruals are one type of future cash flows. CFA thus takes into account both cash basis and accrual basis of accounting and also goes beyond them to recognise all other future real cash flows, including the current value accounting concept of future exit values for an asset (cash inflow) and the future replacement value to replace an asset (cash outflow). Indeed, if one looks at capital budgeting and cash budget one may find cash flow concepts coming into play.

What appears from the above is that CFA considers cash flow on accrual basis and recommends a cash flow theory of accounting approach to the statement of financial position and the statement of changes in financial position, and the deletion of the income statement. Rayman, however, argued that financial reporting should be based upon traditional valuation methods as well as cash flow accounting so that the objectivity of the cash flow accounting can be segregated from the subjectivity of the traditional accounting.

If a complete cash flow accounting system is maintained, the transactions would be entered in the account books of a company when cash is received or paid out, and the income would be basically the difference between all cash received and all cash paid irrespective of the purpose. Further, the cash spent on acquisition of fixed assets would be charged in full to the year of acquisition and depreciation would be automatically abandoned for the purpose of published accounts. Then, the cash spent on acquisitions of materials, fuel, inventories and all other factors would be charged in full at the point of outgoing. But upto now such a complete CFA has not gained any ground. Currently, we are preparing a cash flow statement (CFS) and submitting it before appropriate authority along with conventional financial statements.

The cash flow statement, though described as a basic financial statement, is as a matter of fact, a derived statement. The data presented in this statement are all derived from the profit and loss account and the balance sheet. It has been developed mainly in order to overcome some of the limitations of the accrual-based data presented in the balance sheet and profit and loss account. A few authors have, however, suggested models whereby CFS can be prepared directly by deducting trading payments from trading receipts and adjusting thereto the non-trading receipts and payments. But they also are content with only the preparation of a cash flow statement for an arbitrary period, instead of claiming for a complete recording of transactions on day-to-day basis under CFA system. Thus, to mean CFA we still refer to just the CFS. The CFS exhibits the real net cash flows (RNCF) in a year. This RNCF may be obtained by using the following model that has been designed based on the formula given by a number of accounting writers on this issue.

$RNCF = S - R \pm I - T - D \pm K \pm L \pm A \pm M$ , where

S = Actual and most readily realizable cash inflows from sale

R = Actual and most readily payable cash outflows for operating expenses

I = Real cash flows as interest

T = Cash outflow for taxation

D = Cash outflow as dividend

K = Real cash flows for issue repayment of securities

L = Real cash flows for long term loan

A = Real cash flows for assets sold / purchased

M = Real cash flows for miscellaneous items.

The most important component of the CFS is operating cash flows and this is obtained by the first two items, i.e., S and R, of the model. There are, however, two alternative approaches to presenting cash flow from operating activities—the direct approach and the indirect approach. The approach followed in the model is actually the direct approach. According to the second approach, the net profit figure is the starting point in the computation of cash from operations. Revenue and expense items not affecting cash are added or subtracted to arrive at the net cash provided by operating activities. The indirect approach is easier to apply than the direct one. But the formats as set by the (CA) in AS-3 or by the SEBI in its guidelines all are designed based on the direct approach. As the Indian companies are guided by the professional pronouncements of the ICAI and the direction of the SEBI, it is quite natural that companies of our country will be inclined to adopt the direct approach

to CFS presentation. For this, we give below the format as prescribed by the ICAI. The SEBI-format in this respect is more or less the same.

Cash Flow statement  
(as per AS-3)

	Rs.	Rs.
1. Cash flows from operating activities		
(a) Cash inflows (sale)	* *	
(b) Cash outflows (wage etc.)	<u>* *</u>	
		* *
2. Cash flows from investing activities		
(a) Cash inflows (sale of asset, investment or interest received)	* *	
(b) Cash outflows (Purchase of asset or investment)	<u>* *</u>	
		* *
3. Cash flows from financing activities		
(a) Cash inflows from issue of share etc.	* *	
(b) Cash outflows for redemption, payment of dividend etc.	<u>* *</u>	
		<u>* *</u>
4. Net increase or decrease in cash (1 + 2 + 3)		* *
Add cash at the beginning		<u>* *</u>
Cash at the end		<u><u>* *</u></u>

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### **3.2 Historical Cost Accounting vs. Cash Flow Accounting**

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That historical cost accounting fails to provide relevant information, particularly in times of soaring prices, is known to one and all. During inflation the historical cost charged against revenue cannot recover the exhausted capital fully. Thus, the return on capital is inflated leading thereby to payment of dividend out of capital. This will result in capital erosion which may be termed as the beginning for the end of the firm. Still we resort to historical cost accounting on the plea that this is verifiable and objective. But while arguing in this way in favour of historical cost accounting we do perhaps forget that it is quite possible to illustrate the existence of subjective element in the accounts prepared having based on historical cost.

Historical cost accounting is an accrual-based allocation accounting. At the time of allocation of historical cost over a number of accounting periods, the accountants have to take, into account a numbers of accounting concepts like materiality, relevance, conservatism etc. All will agree that these concepts are nothing but the matters of opinion of different degrees. When we defer cost to match it against future revenues, we cannot but make forecast as to the time and amount of future revenues. Valuation of stock at cost or market price whichever is lower has also a subjective phenomenon. Usually, we follow the realisation principle. But in case of long-term contracts, we recognise revenue arbitrarily before completion of work. A. K. Basu has therefore rightly stated that the measures of wealth and profit provided by the balance sheet and the profit and loss account are just matters of opinion, whereas the only fact in business is cash. So, on the question of objectivity cash flow accounting is no doubt superior to historical cost accounting. Reporting results prepared on historical cost allocation basis can be influenced to a major degree, even in the bounds of professionally accepted practices for the selection of alternative accounting methods, by the self-interest of those controlling the organisation, But this problem of dubious allocation is avoided to a large extent in cash flow basis of accounting. Moreover, the cash flow accounting, by its inherent nature, recognizes time value of money and automatically takes account of inflation. Thus, during inflation also there is no chance of distortion of reporting results in CFA, though this is quite natural under historical cost-based accounting.

Historical cost accounting places too much emphasis on income that distorts the real cash flows in financial statements with the result that the users face a lot of difficulty in applying the information given for decision making. The investors particularly need cash flow measures because they invest cash in anticipation of receiving back cash flows sufficient to justify their investment. In that sense cash flow accounting can be said to be more useful to users in comparison to the conventional historical cost accounting. It is said that earnings or income should be viewed as only a surrogate to cash flow information. So, if earnings do not tell how well a project or division or corporation is doing in terms of cash flows, then the concept and measurement of earnings will be useless.

Historical cost-based accounts emphasize only on past figures preventing directors and managers concerned with shaping various policies and diverse decisions, from taking accurate predictions about the future. They have therefore voiced their dissatisfaction with the conventionally prepared accounting statements. CFA, on the

other hand, is helpful to them as it reports the historic, current and forecasted cash flow data together with assumptions for forecasts and explanations for material deviations.

One of the major limitations of historical cost accounting is that it is not easily understandable by less skilled or unsophisticated users. It is said that accountants prepare accounts only for accountants: But CFA simplifies the financial statements to a large extent by reducing the use of accounting terminology and methodology: Besides, since the financial statements prepared on historical cost basis allow a lot of flexibility in the reported income and financial position, the general users become rather confused. CFA, in that case, tells everything in a straight way enhancing the understandability and comparability of accounting information to users.

In view of so many problems associated with earnings statements prepared under historical cost accounting and a number of advantages of cash flow accounting, people like Hicks have outlined a number of reasons for rejecting the former in favour of the latter. But such a hasty decision is perhaps not desirable. A study of different proposals on cash accounting reveals that it will take time before it is acceptable to conservative accounting profession. Moreover, it needs to be stressed that cash flow for a single period has little relevance. A comparison of cash flows over several periods is necessary to begin to observe the behaviour and frequency of non-recurring flows. Accrual based historical cost accounts of a single period, on the other hand, is sufficient to provide necessary information as to recurring and non-recurring expense and revenue. Besides, the historical cost accounting smooths out the income or cash flows of different years with the help of judicious allocation technique, whereas the cash flow accounting may exhibit a highly uneven picture from year to year. So, it is suggested that CF A information should be reported as supplementary to the historical cost-based profit and loss account and balance sheet.

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### **3.2 Status of CFA**

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In view of importance of CFS in measuring liquidity and solvency position of a firm, it has been made mandatory as part of an essential component of annual accounts in many countries, viz., Australia, Canada, Japan, Newzealand, the UK, the USA etc. But in India a CFS does not form part of financial statement to be prepared under the Companies Act, 1956.

But many companies-particularly the listed ones have started incorporating CFS in their annual accounts. One reason for such a trend in corporate accounting



practices in India is that, as per SEBI guidelines, a listed company is required to prepare, among others, a cash flow statement and get it audited. The ICAI has also revised its accounting standard relating to CFS on the basis of IAS-7 issued by IASC. Following the international trend, a standard on CFS has replaced AS-3 which deals with Funds Flow Statement. The revised AS-3 is recommended.

In the USA, Statement No. 95 issued by FASB in 1987 required companies to prepare CFS from the year 1988. The IASC issued in 1992 a standard on Statement of Changes in Financial Position which deals with cash flow statement. Since international accounting requirements are quite similar with respect CFS according to Statement No. 95 of FASB and AS-3 of ICAI, a brief discussion on any of them may be worthwhile.

According to the aforesaid requirements a CFS is required to be classified into three heads, namely :

- (a) Cash flows from operating activities,
- (b) Cash flows from investing activities, and
- (c) Cash flows from financing activities.

According to Statement No. 95 of FASB, some cash flows relating to financing or investing activities are grouped as operating activities. Examples are : payment of interest on term loan, interest and dividend received. These items are classified as operating cash flows because they normally appear in the income statement. In India, separate treatments have been suggested in the SEBI guidelines and in AS-3, for financial and non-financial companies. For example, 'according to AS-3, for a financial company, cash flows arising from interest paid, and' interest and dividend received should be classified as cash flows from operating activities. In case of other companies, interest paid should be shown under financing activities while interest and dividend received should be shown under investing activities. There is however, no difference in the treatment of dividend paid which should be shown under financing activities in all cases.

Compared to AS-3, SEBI guidelines in this respect are quite flexible. According to SEBI, cash flows from interest and dividend received and paid should each be disclosed separately. Each should be classified in a consistent manner from period to period as either. operating, investing or financing activities. Interest paid and interest and dividend received are usually classified as operating cash flows for financial institutions. However, there is no consensus on the classification of these cash flows for other companies. Interest paid and interest received may be classified as operating cash flows because they enter in to the determination of net profit or



loss. Alternatively, interest paid and interest and dividend received may be classified in financing cash flows and investing flows respectively because they are costs of obtaining financial resources or returns on investments. Dividends paid may be classified as a financing cash flow because they are cost of obtaining financial resources. Alternatively, dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of a company to pay dividends out of operating cash flows.

The IASC has adopted a flexible approach regarding classification of the above items. It allows companies to choose the procedure they like but a consistency in practice is required to be maintained. The ICAI or SEBI is also not so rigid as to the methods of presentation of CFS by reporting companies. This is evidenced by the fact that most of the listed companies in India use indirect method for preparation of CFS, though ICAI and SEBI prefer the direct method. In the USA also, inspite of the preference of FASB to direct method most companies there are found to use the indirect method of CFS presentation. Companies favour indirect method for two reasons : (i) it is simple and easy to prepare and (ii) it focuses on the difference between net income and net cash flows from operating activities.

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### **3.4 Exercise**

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#### **A. Short answer type questions :**

1. Distinguish between cash flow accounting and cash basis of accounting.
2. How does CFA take care of inflationary effect?
3. Name the accounting standard issued by ICAI that deals with CFS.
4. Has the IASC any accounting standard on CFS? If so, mention it.
5. What is SEBI?
6. What do you mean by listing companies?  
[Hints : Companies listed in any stock. market]
7. What are the alternative methods for presenting cash .from operations?
8. Define 'indirect method' for presenting cash from operations.
9. Define cash flow accounting. How does it differ from accrual accounting?
10. How do SEBI guidelines differ from IASC requirements as to the presentation of interest and dividend in CFS?
11. Offer an outline of the cash flow model that is based on the direct method of CFS.
12. State the objectives of CFA.

**B. Long answer-type questions :**

1. Define CFA. What is the justification for CFA?
2. Offer your arguments for and against the replacement of historical cost accounting by cash flow accounting.
3. Discuss the basic features of cash flow accounting. Suggest a format of CFA on basis of its features.
4. What are the advantages of CFA over accrual basis of accounting? Do you agree that the accrual basis of accounting should be dispensed with right now?
5. What is CFS? What is the present status of CFS in India and abroad?

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**3.5 References**

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