Accounting Standard 3 - (AS-3)

Statement of Cash Flows

The standard is not mandatory for small and medium sized companies. However they are encouraged to comply with the standard.

A business needs cash to carry on its operations, clear its obligations and finally meet the expectations of its investors. Stakeholders are curious to know how the business generates and uses cash and cash equivalents.

The objective of this standard is to provide information on historical changes in cash and cash equivalents with the help of a cash flow statement.

A cash flow statement answers the following vital questions:

- Where did cash come from during the period?
- What was the cash used for during the period?
- What was the change in cash balance during the period?

The AS-3 prescribes that the cash flow statement should be prepared in accordance with the standard. All enterprises should provide such a statement as an integral part of their financial statements for each period for which financial statements are prepared. Further, all enterprises that prepare financial statements in accordance with IFRS (International Financial Reporting Standards) are required to prepare a cash flow statement. The equivalent standard under IFRS is Ind AS 7.

The definition of ‘cash and cash equivalents’ is an important part of preparation and interpretation of cash flow statements.

Cash consists of cash on hand and demand deposits, coins and notes of an enterprise.

Cash equivalents are short term, highly liquid investment that are readily converted into a known amount of cash and which are subject to an insignificant risk of change in value.

Guidance notes states that an investment can be normally defined as cash equivalent if its maturity is 3 months or less from the date of acquisition. Equity investments are generally excluded. Preference shares specifically due for redemption within 3 months can be included. Bank overdrafts that are repayable on demand are included.

Cash flow statements should be classified under the following standard headings:

- Operating Activities
- Investing Activities
- Financing Activities

➢ **Operating Activities**

The cash flow from operating activities is derived from the principal revenue producing activities of the enterprise. These transactions are the ones that result in profit or loss. The cash generated at this stage is a key indicator of the extent to which the business is able to maintain the operating levels, repay loans, pay dividends, and make new investments without recourse to further funding.

Examples of cash flows from operating activities of the business would include:

- Cash receipts from sale of goods or services
- Cash receipts from royalty, fees, commission and other revenues
- Payment to suppliers of goods and/or services
- Payment to employees
- Receipts and payments of income taxes related to operations. Taxes paid or received specifically identifiable to a financing or investing activity would be classified under those respective heads.

Gain on sale of furniture would not form part of operating activities but investing activities. However if the enterprise is in the business of selling furniture, such gains would be classified under operating activities. Interest received on short term investments should appear under this head. Interest paid for working capital loans is an operating activity.

➢ **Investing Activities**

The cash flow related to investing activities are those from acquisition and disposal of long term assets and investments that are not ‘cash equivalents’. Interest paid or received from long term loans or investments should be disclosed under this head. Cash flows pertaining to acquisition and disposal of subsidiaries or other business units should be disclosed separately under this head.

- **Financing Activities**

Cash flows resulting in changes in the capital and borrowing structure of the enterprise is classified under this head. Dividend paid is always under financing activity and disclosed separately.

A company that complies with this standard should report cash flow from operating activities by the Direct or Indirect method.

Under the direct method, major classes of gross cash receipts and payments are disclosed. This method helps in estimating future cash flows which is not possible under the indirect method. The information disclosed here is available from the accounting records of the enterprise or by adjusting sales, cost of sales, expenses and income in the profit and loss account to arrive at changes in inventory, payables or receivables.

When applying the indirect method, net cash flow from operating activities is arrived at by adjusting net profit or loss for effects of changes in transactions of non cash nature.

Effects of changes in cash or cash equivalents as a result of foreign currency fluctuations should be disclosed separately in the cash flow statement.

Extraordinary items are classified under the head operating, investing or financing depending on the nature of the expenditure.

Needless to say any non cash transaction does not form part of the cash flow statement.

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