

The background of the page is a photograph of a curved asphalt road with a concrete curb, viewed from a low angle. A large, semi-transparent blue geometric shape is overlaid on the right side of the image, containing the text. The text is white and centered within the blue area.

BANGLADESH
COST ACCOUNTING
STANDARDS
BCAS - 18

Cash Flow

BCAS 18: Cash Flow

18.1 Introduction

Cash flow in a company is a very important issue from managerial perspective. Forecasting cash flows are very important for decision making purposes. Reporting cash flow related information for internal decision making process receives extra attention along with external reporting. At the same time, management of cash flows on a regular basis is an important task of treasury now-a-days. The firms need to maintain a delicate balance between holding too much cash resulting into sacrifice of profitable investment opportunities and too little cash triggering unnecessary borrowing to support daily transactions. The purpose of this standard is to consider issues in developing and using cash flow information from a forward looking perspective. Sometimes it has been observed that in spite of adequate profit in business, they are unable to meet their taxes and dividends, just because of shortage of cash. Improving cash flow is a smart move for any business. It does not matter how great the business model is, how profitable it is, or how many investors the business has lined up. The business cannot survive if it fails to manage its cash properly. Given these trends, it is becoming increasingly important that cash flow information be prepared in a consistent and reliable manner.

18.2 Objectives

The standard provides a basic guideline on forecasting cash inflows and outflows, reporting of cash flow related information, analyzing cash flow data and using cash flow data in different typical situations. The standard also highlights the importance of generating accurate cash flow information timely which is very important for cash flow management.

18.3 Scope

- 18.3.1 This standard provides guidelines for generating and using cash flow related information for decision making purpose.
- 18.3.2 More particularly, the standard covers the following area relating to cash flows:
- Forecasting cash inflow and outflow related information;
 - Reporting cash flow information;
 - Analyzing cash flow information critically; and
 - Applying cash flow information.
- 18.3.3 This standard may be followed by companies and other business or non-business organizations where cost and management accounting is in practice either as a statutory obligation or to support management decision making process.

18.4 Key Features

The key features of this standard are pointed below -

- Identifying the use of cash flow information;
- Presenting importance of cash flow;
- Cash flow reporting across operating, investing, and financing activities;
- Presenting cash flow related ratios; and
- Explaining strategic four factor models.

18.5 Definitions

The following terms are used in this standard with the meanings specified -

- 18.5.1 Cash: The meaning of cash is cash in hand and cash at bank including deposits.
- 18.5.2 Cash and Cash Equivalents: Cash and cash equivalents imply readily convertible, highly liquid investments, the value of which in cash is well-known to us without risk of change in its realization amount. The purpose of keeping cash equivalents is to meet current and short-term commitment rather than for investments. Only those investments having short maturity terms qualify as cash equivalents.
- 18.5.3 Cash Flows: There are two types of flows: inflows and outflows. If the increase in cash is the effect of transactions, it is called inflows of cash; and if the result of transactions is decrease in cash, it is called outflows of cash.
- 18.5.4 Free Cash Flow: Free cash flow represents the cash that a company is able to generate after spending the money required to maintain or expand its asset base. It is calculated as operating cash flow minus capital expenditures.

18.6 Standards

- 18.6.1 **There are two broad perspectives of cash flow information: internal, which projects cash flows to provide a basis for planning and project evaluation along with complement external information with respect to asset valuation, and external, which provides summary information primarily for the purpose of reporting to shareowners.**
- 18.6.2 Developing external cash flow information has been the traditional domain of financial reporting. For this reason, and because internal cash flow information is the primary source of decision-making information and therefore closely related to the domain of management accounting, this standard will focus on developing internal cash flow statements. However, it presents cash flow statement as a reference at appendix which is also an integral part of this standard.
- 18.6.3 Three basic issues involved in preparing and reporting internal cash flow information are:
- a) how the information is to be gathered;
 - b) how it will be presented; and
 - c) how it will be used.
- 18.6.4 Given the increasing reliance by decision makers inside and outside organizations on internal cash flow information, it is becoming more and more important that information be developed in a systematic and reliable way. Therefore, it is imperative that there be a systematic process in place to develop the cash flow forecasts that underlie internal cash flow statements. This process will require soliciting forecast information from operations personnel, who are most qualified to estimate that information, and triangulating those estimates with historical information, when available. Experience and sound judgment are required. Moreover, operations personnel should evaluate those forecasts once the internal cash flow statement has been constructed to determine the reasonableness of those forecasts.
- 18.6.5 **The presentation form and periodicity of the cash flow forecast should reflect the**

identified needs of the users of that information. However, such information will not contradict with the cash flow statement prepared for general purpose financial statements rather supplement that information to serve micro needs of internal decision makers.

- 18.6.6 Internal cash flow analysis plays a critical role in evaluating proposals to acquire new assets or in valuing existing assets. It is evident that accurate cash flow projections are critical in that they will directly affect the resulting asset valuations, which, in turn, will affect the decisions that rely on those valuations. In this regard, it will often be useful to develop an analysis to determine the sensitivity of the decision to the cash flow forecast.
- 18.6.7 Increased global competitiveness has caused managers to look for new ways to improve profitability and return on investment. One of the approaches used to increase return on investment has been to reduce the level of idle or underused assets in the organization. In this vein, proponents of economic value added have argued that one of its major benefits is to use a charge on invested capital to encourage managers to better manage the firm's asset base by identifying and eliminating underperforming assets. This general interest in managing assets more effectively has included a heightened interest in managing cash in particular. This, in turn, has increased interest in developing better ways of forecasting cash flows so that plans can be made to invest surplus cash or of identifying cash requirements far in advance in order to arrange operating loans at the most favorable interest rates.
- 18.6.8 Forecasting cash flow is a critical activity which should be a team work. It requires SORS analysis as given in appendix which is completely a management process. And for the quantitative part, it requires a careful analysis covering every unit who possess very important information for forecasting. The first issue in developing a cash flow forecast is to identify the group or individual responsible for managing the process. Few first hand guideline may be cited below:
- a) Because of their experience and traditional responsibility for managing cash, the Treasury group will usually be responsible for managing the cash flow forecast. In developing these forecasts, the Treasury group should rely on those organizational members who are in the best position to provide reliable estimates.
 - b) The Marketing Group will be in the best position to estimate sales.
 - c) The Manufacturing Group will be in the best position to estimate manufacturing costs.
 - d) The senior finance committee will be in the best position to estimate discretionary expenditures such as net asset investments and research and development.
- Beyond providing a basis from which to develop more reliable forecasts, involving other organizational groups provides a motivation for commitment to these forecasts. This commitment is both valuable and necessary when the cash flows are to be used for evaluation purposes.
- 18.6.9 Other sources for developing cash flow information are archival records such as the organization's accounting system and various costing statements. These records contain the historical relationship between cash flows and prior decisions and provide a basis for assessing current estimates.
- 18.6.10 **Another important issue in cash flow forecast is the timing issue. The cycle of developing and presenting information (periodicity) must be matched to the decisions that will be based on the information. For example, when financing**

decisions are made quarterly, it will be necessary to develop quarterly estimates of cash flow requirements or excess cash balances that will have to be invested so that they do not lie idle. The most common forecasts are quarterly or monthly. In general, the periodicity of the forecast requirement will shorten as the seasonality or the variance of cash flows increases.

- 18.6.11 Next important issue in developing the cash flow forecast is to choose the appropriate format. There are two approaches: the financial statement approach, which develops the information from the published financial statements, and the traditional approach, which computes cash inflows and outflows directly. Follow the appendix to understand the technicality.
- 18.6.12 It would appear that the financial statement approach is the most widely used approach by analysts outside the organization who develop cash flow information based on published financial information. When prospective cash flow forecasts are developed internally, the traditional approach is widely used. There is no single approach to developing cash flow information that is best in all circumstances. The appropriate approach to use is the one that is best in the particular circumstances in terms of meeting the users' requirements.
- 18.6.13 For external reporting purpose, cash flow analysis is done across three different activities, e. g., operating, investing and financing. If decrease in cash is due to cash management rather than its operating, investing, and financing activities, it will be excluded from cash outflows. Cash management means investment of cash in cash equivalents.
- 18.6.14 The primary external role of cash flow information is valuation. The periodic cash flows attributable to an asset, whether it is an entire organization or a single asset, are discounted at an appropriate rate to determine the intrinsic value of the asset. Internally, prospective cash flow information is used to value existing or prospective investments. Beyond this, prospective cash flow information is used to manage treasury operations so as to minimize the cost of borrowing and minimize opportunity losses from holding idle cash. In addition, prospective cash flow information may be used in a control setting by providing a basis from which actual cash flows are evaluated.
- 18.6.15 Established businesses often have a buffer of extra cash to get them through shortfalls. Growing businesses often don't because they are always reinvesting. Years with the biggest growth-including the first few years-are also the most challenging when it comes to cash flow. This is one of the reasons it's so hard to get a new business off the ground.

18.7 Recording and Reporting

- 18.7.1 Organization should have a policy to handle cash flow. There should be a clear demarcation line between internal and external use of cash flow information.
- 18.7.2 Organization's policy should mention, to the minimum, the following issues:
- a) Persons responsible for forecasts
 - b) Persons responsible for finalization
 - c) Range of use of cash flow information
 - d) Timing of cash flow forecast
 - e) Formal channel of communicating cash flow information
 - f) Any other pertinent issues

- 18.7.3 To evaluate the performance of forecasting, using, managing and controlling cash flow information, following ratios can be used:
- a) Operating Cash Flow / Sales Ratio: This ratio, which is expressed as a percentage, compares a company's operating cash flow to its net sales or revenues, which gives investors an idea of the company's ability to turn sales into cash.
 - b) Free Cash Flow / Operating Cash Flow Ratio: This ratio measures the relationship between free cash flow and operating cash flow.
 - c) Operating Cash Flow per Share: Cash flow per share is a financial ratio that measures the operating cash flows attributable to each share of common stock. It is a variation of the earnings per share which substitutes net income with net cash flows from operations.
 - d) Cash Flow Coverage Ratio: This ratio measures the ability of the company's operating cash flow to meet its obligations - including its liabilities or ongoing costs.
 - i. Short-Term Debt Coverage = $\frac{\text{Operating Cash Flow}}{\text{Short-term Debt}}$
 - ii. Total Debt Coverage = $\frac{\text{Operating Cash Flow}}{\text{Average Total Debt}}$
 - iii. Capital Expenditure Coverage = $\frac{\text{Operating Cash Flow}}{\text{Capital Expenditures}}$
 - iv. Dividend Coverage = $\frac{\text{Operating Cash Flow}}{\text{Cash Dividends}}$
 - v. CAPEX + Cash Dividends Coverage = $\frac{\text{Operating Cash Flow}}{(\text{Capital Expenditures} + \text{Cash Dividends})}$
 - e) Dividend Payout Ratio: This ratio identifies the percentage of earnings (net income) per common share allocated to paying cash dividends to shareholders. The dividend payout ratio is an indicator of how well earnings support the dividend payment.
 Dividend Payout Ratio = $\frac{\text{Dividends per Common Share}}{\text{Earnings per Share}}$
 - f) Price / Cash Flow Ratio: The price to cash flow ratio is often considered a better indication of a company's value than the price to earnings ratio. It is a really useful ratio for a company to know, particularly if the company is publicly traded. It compares the company's share price to the cash flow the company generates on a per share basis.
 Price/cash flow ratio = $\frac{\text{Share price}}{\text{Operating cash flow per share}}$

18.8 Effective Date

This standard will be effective from January 1, 2017 onwards.

Appendix 18A

Classification of Cash Flows and Presentation for External Reporting

Cash flows should be classified in three main categories:

- Cash Flow from operating activities
- Cash Flow from investing activities
- Cash Flow from financing activities

a) Cash flow from operating activities

Inflow of cash from operating activities represents the level of sufficient cash generation necessary to maintain operating capability without recourse to external resource of financing. In other words, operating activities mean principal revenue-generating activities of a firm. It represents those transactions that determine the profit or loss of a firm. Some examples of cash Flows from operating activities are given below:

- Cash sale (goods or services)
- Cash receipts from commission, fees and royalties income etc.
- Cash payments to workers or employees in form of salary or wages.
- Cash payments to supplier of goods or services.
- Cash receipt on account of insurance premium by insurance companies.
- Cash payments in form of claims, annuity and other benefits.
- Cash payments or refund of income tax in case not included in investing or financing activities.
- Cash payments on account of current and future contracts.

Note: Cash receipt on sale of plant and machinery comes under category of investing activities.

b) Cash flow from investing activities

Assets and long-term investments that do not come under cash equivalents are known as investing activities. Investing activity represents how much investment in long-term assets has been made to earn profit in future. Some examples of Cash Flows from investing activities are given below:

- Cash payments to acquire tangibles and intangibles assets including construction of assets and capitalization of research and development cost.
- Cash receipts from sale of investments and disposal of fixed assets.
- Cash payment for investments in shares, warrants and debentures of other companies etc. excluding those which are covered under cash equivalents or purchased for trading purpose. If so, those come under operating activities.
- Cash received from disposal of or sale of shares, warrants or redemption of funds other than those which are kept for trading purpose.
- Advances or loan made to third party other than by financing companies.
- Cash payment for future contracts other than trading purpose.
- Cash received from future contracts other than trading purpose.

c) Cash flow from financing activities

The activities which may result in change in size and composition of owner's capital including preference shares are called financing activities. Separate disclosure is important for financing activities. Examples of Cash flows from financing activities include cash received on issue of shares, debentures, loans, bonds and other short or long term borrowings, cash payments on redemption of debentures bonds, preference shares etc.

Treatment of Some Typical Items: The treatment of some typical cash flow items is discussed below:

Extraordinary Items

Inflow or outflow of cash is classified according to the nature of activities that may be operating, investing, or financing activities. Cash flow due to extraordinary items should be shown separately in the cash flow statement to enable users to understand its nature and effect on the cash flow statement.

Interest and Dividends

If cash flow arises due to interest paid or interest and dividend received, then that should be classified as operating activities in case of "financial enterprises". In case of "other than financial organizations", the interest paid should be classified as financing activity and the interest and dividends received should be classified as investing activity. Dividend paid should be classified as financing activity in both the cases.

Taxes on Income

Taxes on income should be separately disclosed and should be classified under operating activities in most of the cases except where we can easily identify the taxes according to the nature of income but if total amount of tax is given, then it should be classified as operating activities. However, dividend distribution tax will be classified as financing activities.

Cash flows from acquisition and disposal of subsidiaries and other business units

Cash flow arises due to acquisition or disposal of subsidiary should be shown separately and classified as investing activities. This transaction should be easily identifiable in cash flow statement to enable users to understand the effect of it. The cash flow of disposal is not deducted from cash flow of acquisition.

Foreign Currency

Items appearing in a cash flow statement should be shown in local currency value, applying actual foreign currency rate of the particular day on which cash flow statement is going to be prepared. Effect on value of cash and cash equivalents as reflected in the cash flow statement due to change in rate of foreign currency should be shown separately as a reconciliation of changes. Due to change in foreign currency rate, unrealized gains and losses are not cash flows. However, effect on cash and cash equivalents held or due in foreign currency are reported in cash flow statement in order to reconcile the cash and cash equivalents at the beginning and at the end of the period.

Non-Cash Transactions

Some investing and financing activities do not have any direct impact on cash flows. For example, conversion of debt to equity, acquisition of an enterprise by means of issuance of share, etc. Those transactions should be excluded from cash flow statements, in which there are no uses of cash or cash equivalents. There are other financial statements in which those investing and financing activities appear separately.

Specimen Format: Direct and Indirect Method

XYZ LIMITED Cash flow Statement for the year ended YYYY	
Particulars	Amount
Cash Flows from Operating Activities (Schedule- 1A for Direct, 1B for Indirect)	XX
Cash Flows from Investing Activities (Schedule- 2)	XX
Cash Flows from Financing Activities (Schedule-3)	XX
Extraordinary Items	XX
Net Increase or Decrease in cash or cash Equivalents before Tax →	XX
Income Tax Paid →	XX
Net Increase or Decrease in cash or cash Equivalents →	XX
Add: Cash & Cash Equivalents at the beginning of the period →	XX
Cash and Cash Equivalents at the end of the period →	XXX

Schedule 1A: Cash Flow from Operating Activities (Under Direct Method)

Particulars	Amount	Amount
Cash received from customers		XXX
Cash paid for:		
a) Suppliers for Purchases	XX	
b) Wages & Salary	XX	
c) Operating and General administrative expenses	XX	XXX
Net Profit before Taxes →		XX
Income Tax Paid →		XX
Cash flow from Operating Activities →		XXX

Schedule 1B: Cash Flow from Operating Activities (Under Indirect Method)

Particulars	Amount
Changes in Profit & Loss account	XX
Changes in Reserve (Any)	XX
(+) Interim Dividend	XX
Net Profit →	XXX
Non Cash Items:	
(+) Depreciation	XX
(+) Loss on Sale of Fixed Assets	XX
(+) Goodwill Amortization	XX
(+) Preliminary Expenses written off	XX
Non Cash Incomes:	
(-) Gain on Sale of Fixed Assets	XX
Operating Profit before working Capital changes →	XXX
± Changes in Current Assets & Current liabilities	XX
Cash operating Expenses before Tax	XXX
Tax Paid	X
Cash Flow from Operating Activities →	XXX

Schedule 2: Cash Flow from Investing Activities

Particulars	Amount	Amount
Cash received for:		
a) Sale of Fixed Assets	XX	
b) Sale of Investment	XX	
c) Interest received	XX	
d) Dividend received	XX	XXX
Cash paid for:		
a) Purchase of Fixed Assets	XX	
b) Purchase of Investments	XX	
Net Cash Flow from Investing Activities →		XXX

Schedule 3: Cash Flow from Financing Activity

Particulars	Amount	Amount
Cash received for:		
a) Issue of Equity Shares	XX	
b) Issue of Preference Share	XX	
c) Long-term borrowings	XX	XXX
Cash paid for:		
a) Interest paid	XX	
b) Redemption of Preference shares	XX	
c) Repayment of Loans	XX	
d) Dividend paid	XX	
e) Purchase of Investments	XX	XXX
Net Cash Flow from Financing Activities →		XXX

Appendix 18B

The Financial Statement Approach vs. Traditional Approach

Financial Statement Approach

The financial statement approach uses financial statement information to develop two broad definitions of cash flow: cash flow to equity holders and free cash flow. Table below illustrates the calculation of cash flow to equity holders.

	Sales
+	Non-Operating Income
-	Cost of Goods Sold
-	Selling, General, and Administrative Expenses
-	Research and Development Expenses
-	Depreciation
=	Net Income Before Interest and Taxes
-	Interest
=	Net Income Before Taxes
-	Taxes
=	Net Income After Interest and Taxes
+	Non-Cash Expenditures
-	Change in Working Capital
-	Preferred Dividends
=	Cash flow to Equity Holders

The second common definition of cash flow is free cash flow. Table below illustrates the calculation of free cash flow.

	Sales
+	Non-Operating Income
-	Cost of Goods Sold
-	Selling, General, and Administrative Expenses
-	Research and Development Expenses
-	Depreciation
=	Net Income Before Interest and Taxes
-	Taxes
+	Non-Cash Expenditures
=	Operating Cash Flows
-	Change in Working Capital
-	Capital Expenditures
-	Changes in Other Assets
=	Free Cash Flow of Assets

Note that both of these approaches add back the non-cash expenditures to compute cash flows. This eliminates some, but not all, of the manipulations to GAAP income that result from using different, but acceptable, GAAP.

Traditional Cash Flow Statement

There are two approaches used to prepare the statement of cash flows. The direct method begins by using cash inflows and outflows to compute the net cash flow from operations. Then cash inflows and outflows from investing activities are identified to compute the net cash flow from investing activities. Finally the cash inflows and outflows from financing activities are used to compute the net cash flow from financing activities. Table below illustrates the format of the direct method.

Cash Flows from Operating Activities	
Collected from Customers	xxx
Dividends and Interest on Investments	xxx
Payments for Goods	(xxx)
Salaries and Wages	(xxx)
Income Taxes	(xxx)
Interest on Liabilities	(xxx)
Net Cash Flow from Operating Activities	xxx
Cash Flows from Investing Activities	
Sale or Disposal of Property, Plant, or Equipment	xxx
Sale of Investments	xxx
Purchase of Property, Plant, or Equipment	(xxx)
Purchase of Investments in Securities	(xxx)
Net Cash Flow from Investment Activities	xxx
Cash Flows from Financing Activities	
Borrowing from Creditors	xxx
Issuing Equity	xxx
Repayment of Debt	(xxx)
Dividends Paid	(xxx)
Net Cash Flow from Financing Activities	xxx

The indirect method of preparing the cash flow statement begins with net income and finds net cash flow from operating activities by eliminating noncash items included in net income. The

indirect method computes net cash flows from investing and financing activities using the same approach as the direct method.

Table below illustrates the indirect method of computing net cash flow from operating activities.

Cash Flows from Operating Activities	
Net Income	xxx
Adjustments for Non Cash Items in Income	
Depreciation	xxx
Gain on Sale of Equipment	(xxx)
Changes in Current Accounts	
Increase in Accounts Receivable	(xxx)
Increase in Accounts Payable	xxx
Net Cash Flow from Operating Activities	xxx

Appendix 18C

Strategic Four Factor (SORS) Model

In general, this requires the application of what, in strategic company management, has come to be known as the strategic four-factor model called "SORS". The letters that make up SORS stand for:

- ✓ Strategic planning (S)
- ✓ Organizational planning (O)
- ✓ Resource requirements (R)
- ✓ Strategic control (S).

The following figure summarizes the simplified matrix of interacting factors and component parts that make up 'SORS'. In general terms, SORS is influenced or determined by four major factors: the external environment, the internal environment, organizational culture and resource (especially funds) availability. These four factors interact to create four inter-related components which normally determine the success or failure of any given company. These are:

- a) □ competitive environment
- b) □ strategic thrust
- c) □ product/market dynamics
- d) □ competitive cost position and restructuring

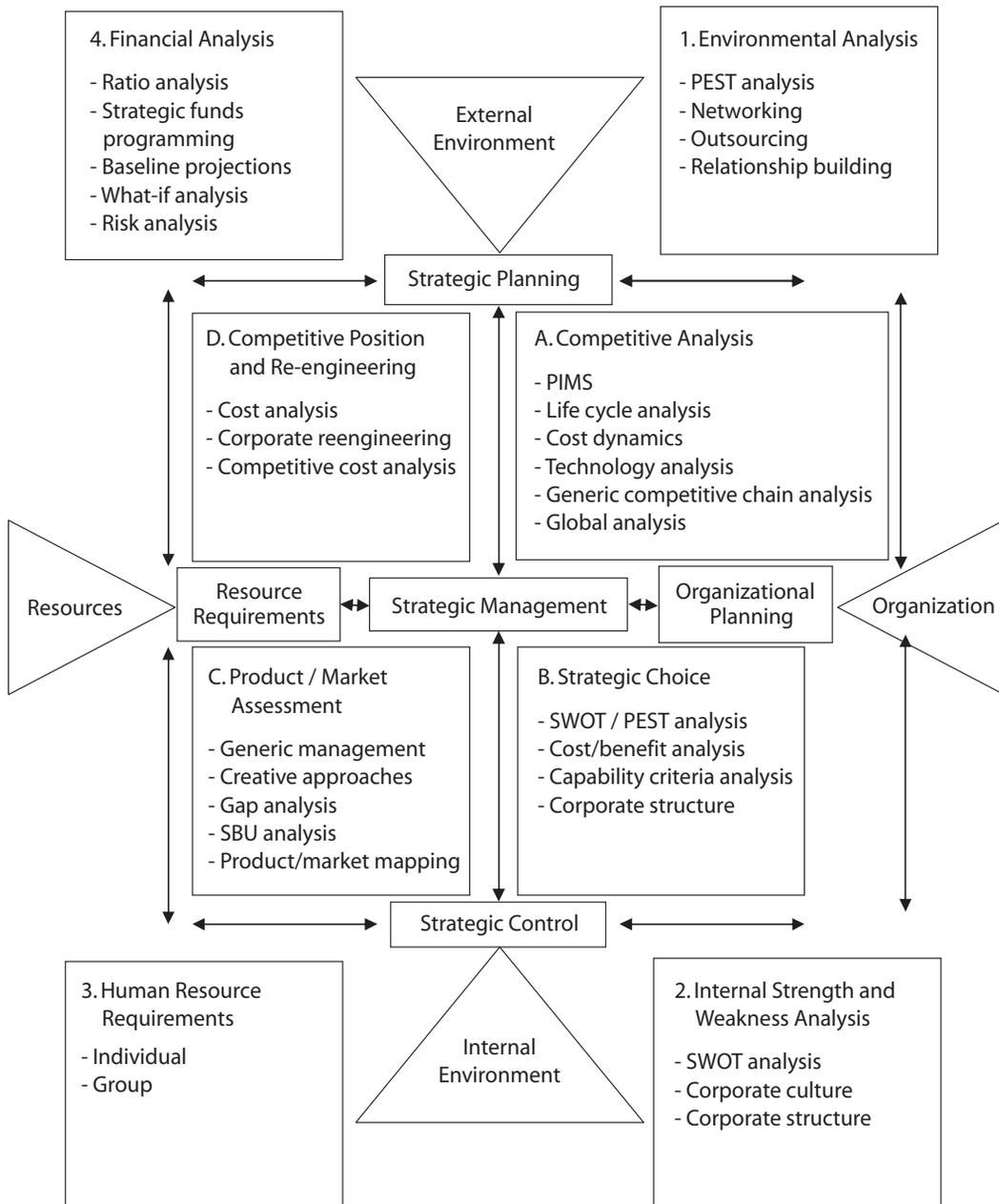
A proper and pragmatic manipulation of these four component parts requires:

- ✓ assessing the external environment
- ✓ understanding the internal environment
- ✓ adopting a leadership strategy
- ✓ strategically planning the finances of the company

The purpose of this standard is not to cover all the components, rather concentrating on proper understanding of financial analysis for strategic planning. This requires a sound financial analysis backed by strategic funds programming, baseline projections (or budgeting), what-if (decision tree) analysis, and risk analysis.

Almost everyone is familiar with the substantial capital demand in all forms of business. Obviously, this does not all have to be owned capital. Evaluation of successful businesses has found that many of them operate with 50 percent or more rented or borrowed capital. The pressure on businesses to grow is likely to continue, and these businesses are likely to grow

faster than will be permitted by each reinvesting its own annual savings from net income alone. Thus, because demand for credit will continue to expand, careful credit planning and credit use decisions are of paramount importance to marketing companies in any country.



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