CHAPTER 10

Sources and Application of Funds

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The most commonly used forms of the Statement of Changes in Financial Position are Sources and Application of Funds (Funds Flow Statement) and Cash Flow Statement.

10.1 NEED OF FUNDS FLOW STATEMENT

Profit and Loss Account and Balance Sheet are the two basic financial statements, which are of immense importance to owners, management and investors. When Profit and Loss Account and Balance Sheet are prepared, what is the need of preparing this separate Funds Flow Statement, again? Balance Sheet shows the summary of assets and liabilities of a firm. The assets side of the balance sheet shows the deployment of funds, while the liabilities side shows how the resources have been raised. In other words, balance sheet shows sources and uses of finance too. It indicates the financial position of a firm on a particular date.

> **Balance Sheet is a static statement and does not show the causes for the changes in assets and liabilities or movement of finances, between two periods. To meet this requirement, funds flow statement is needed.**

Balance Sheet does not show the changes that take place during the period. If loan has been raised and repaid during the same period, balance sheet, at the end of the period, does not show both the transactions. Similarly, Profit and loss account shows the expenses and revenues realised for an accounting period. **Profit and Loss Account also reflects the operational results of a business for a particular period, which causes changes in owners' equity, partially.** Capital raised and funds withdrawn resulting in change in owner's equity does not appear either in Profit and Loss Account or Balance Sheet. In other words, Profit and loss account explains only partial story in respect of owner's equity. Profit and Loss Account and Balance Sheet provide the basic essential information about the business activities of the firm. **However, both these two statements do not explain the causes for changes in assets, liabilities and owner's equity.** Moreover, usefulness of both balance sheet and profit and loss account is limited and fail to serve the purposes of financial analysis and planning.

It is clear, from the above, that Profit and Loss Account and Balance Sheet do not provide, sufficiently, wide range of information to make assessment of the organisation by the end user for the purpose of analysis and planning. **So, there is a need to prepare a separate statement that explains the changes in assets and liabilities, from one period of time to the end of another period. The statement is called "Funds Flow Statement".**

Purposes: Both Profit and Loss Account and Balance Sheet do not explain the changes in assets, liabilities and owners' equity between two dates. So, an additional statement is needed to serve this purpose. Funds Flow Statement serves this purpose. Funds Flow Statement, broadly, serves the following purposes. The Funds Flow Statement shows:

(i) Changes in assets and liabilities, including working capital, between two periods and

(ii) Utilisation of financial resources during the period such as acquisition of assets, payment of debts and distribution of dividends to shareholders etc.

10.2 CONCEPT OF FUNDS

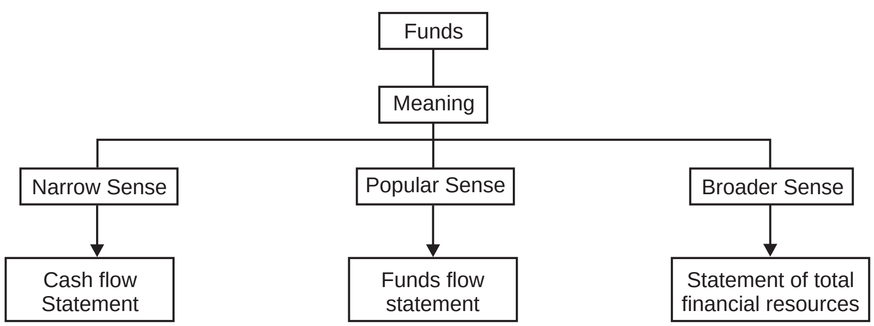
The term 'Funds' has been defined in a number of ways. They are:

(A) In the Narrow sense: Here, the term 'funds' refer to cash only. Transactions that involve cash only are taken. **Cash Flow Statement is prepared, in this approach, where only cash receipts and disbursements are included. It is a summary of cash transactions.**

(B) In the Popular sense: 'Funds' refer to working capital, the excess of current assets over current liabilities. Total resources of a business are invested in fixed assets and working capital; the later is partly in the liquid form. **This is the most popular form of 'Statement of Changes in Financial Position'. Sources and Application of Funds is prepared on this basis.**

(C) In the Broader sense: The term 'Funds' refer to financial resources, in whatever form, they may exist. **Statement of Total Financial Resources is prepared as per this approach.** This is a comprehensive statement involving cash and non-cash transactions. Transactions involving money, materials, machinery and others are included. When machinery or building is purchased, in exchange of shares, it is not reported both in cash flow statement and Sources and Application of Funds. However, this type of transaction involves financial resources and so finds place in the Statement of Total Financial Resources. All types of transactions involving financial resources are included in this statement.

The working capital concept of funds is the most popular one, as already stated, amongst the different ways of defining the term 'Funds'. **In this chapter, when we discuss Sources and Application of funds, the term 'funds' refer to working capital only.**



Meaning of 'Funds'

In the context of 'Source and Application of Funds Statement', the term 'Funds' mean 'working capital'.

This statement shows the increase or decrease of working capital during a specified period. Further, this statement provides information for the causes or reasons for increase / decrease of working capital. From which sources, working capital is raised or to what purposes there has been diversion of working capital is known from this statement.

In other words, the story behind the change in the financial position between the beginning and end of a period is known.

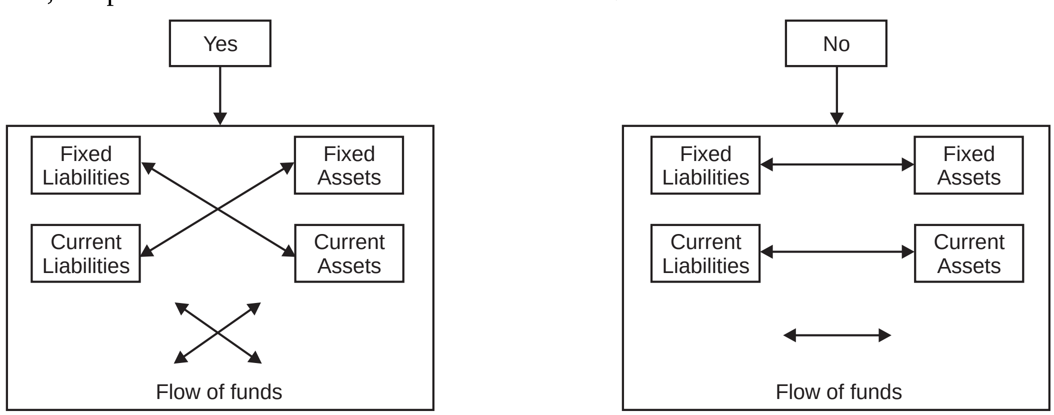
10.3 MEANING OF FLOW OF FUNDS

The term 'Flow' refers to movement of funds. The movement can be in the form of increase or decrease of funds i.e. working capital. If a transaction creates a change in the quantum of working capital, 'flow' of funds takes place. The transaction may increase or decrease the existing amount of working capital. Every transaction has two sides. Let us take some examples to explain the concept of flow of funds. Issue of shares for cash results in increase of working capital, it is a transaction of 'Source'. The transaction has resulted in 'inflow' of funds. Purchase of furniture on credit reduces the amount of working capital; it is 'Application' of funds. There is outflow of funds with the transaction.

There would be change in working capital, if one of the items is related to current assets or current liabilities. Ask the transaction whether it would result in change – increase or decrease working capital. If the answer is yes, the transaction finds a place in "Working Capital Statement".

If the transaction does not change the amount of working capital, it is said to be non-fund transaction and does not appear in the Sources and Uses of Funds Statement. In a non-fund transaction, both the items are non-current or current items. We are referring to current assets and current liabilities. When machinery has been purchased and in consideration debentures are issued, the transaction has not changed the working capital as both the items are non-current. It is a non-fund transaction. If cash is realised from debtors, there is no increase in working capital as both the items are current items. These types of transactions do not appear in the sources and application of funds statement.

Simple Rule: The simple rule is "Ask the transaction, whether it changes working capital", if it is 'YES', the transaction finds a place in Sources and Application of Funds. If the answer is 'NO', no place for the transaction in the Statement.



Flow of Funds

10.4 MEANING & OBJECTIVES - FUNDS FLOW STATEMENT

Meaning and Definition: Funds Flow Statement is a device that indicates the various means through which funds have been obtained, during a specified period and the ways they have been used. Simply, it shows the different sources of procuring funds and their varied application during that period. It shows the inflow and outflow of funds.

> **The term 'funds' refer to working capital. Funds Flow Statement shows the change in financial position of a firm between beginning and ending financial statement dates.**

Foulke defines this statement as:

"A statement of sources and application of funds is a device designed to analyse the changes in financial condition of a business enterprise between two dates".

The statement has two sides, the left side shows the sources and the right side presents their uses.

The statement is an important tool for financial analysis for the management, bankers and investors who are interested in knowing the changes in the financial position of the firm. It is a supplement to the financial statements. Banks insist on this statement as and when loan application is submitted for financial assistance.

Now, Funds Flow Statement is a mandatory requirement of reporting in India for limited companies.

Funds Flow Statement is called by various names such as:

(i) Statement of Sources and Uses of Funds

(ii) Where got, where gone Statement

(iii) Statement of Inflow and Outflow of Funds

(iv) Funds Received and Funds Disbursed Statement

(v) Statement of Sources and Applications of Funds

As observed rightly, the key word is 'Funds'.

Importance and Objectives of Funds Flow Statement: This statement is widely used by the financial institutions, banks, credit rating agencies and management. By preparing the statement, the management can know well, in advance, about the adequacy or otherwise of working capital position for proper planning.

1. **Analysis of Financial Position and Profits:** Balance sheet is a static statement about the financial position, on a particular date. It shows the net effect of various transactions on the operational and financial position of a concern. It does not explain the causes for the change in assets and liabilities, between two different dates.

> **The fund's flow statement explains its effect on the liquidity position of the organisation. At times, even after the firm is profitable, still, it experiences**

difficulty in meeting normal payments. Firm does not understand reasons for such a situation. Sources and Application of Funds gives the answers for these questions.

2. **Throws light on perplex questions:** Questions of general interest but answers not available, elsewhere, are found from this statement such as:
   (i) Why firm is not able to declare higher dividend, despite increase in profits?
   (ii) Where the proceeds of shares and debentures have gone?
   (iii) In what manner, the sale proceeds of fixed assets have been used?
   (iv) What are the sources of repayment of long-term debts?
   (v) How the increase in working capital requirement was financed and how further requirements would be met?
3. **Information of Profit from operations and non-operations:** Profit and Loss Account shows the summary or net effect of operating and non-operating expenses, in the form of net profit. In other words, operating and non-operating profit is not calculated and shown separately.

   Firm may be in net profit, due to non-operation profit, even after offsetting the operating losses. This alarming picture is not known from the profit and loss account for timely action. Funds Flow Statement shows the operating and non-operating profit, separately, that helps timely managerial action.

4. **Management of Working Capital:** Statement of changes in working capital reveals to management the ways in which working capital was obtained and used in the past. Projections are always prepared by the management to achieve future plans.

   A projected statement of working capital may reveal the need of large amount of working capital. In case, the firm is not able to meet the future working capital needs from internal resources, it can plan, in advance, to procure to meet its needs.

5. **Helps in Borrowing Decision:** Nowadays, banks and other financial institutions insist on the submission of Funds Flow Statement, along with loan application. This helps the bank to assess the working capital needs of the firm.

   Based on this statement, banks consider whether to sanction working capital limits or not and if so to what extent, the limit is to be sanctioned. This statement also facilitates the long-term institutions to appreciate the means of the firm for repaying the installment on long-term debt. This is a necessary statement both for commercial banks and long-term institutions, while assessing the borrowing needs of the firm.

6. **Knowledge of Sources and Uses:** Sources in the Funds Flow Statement provide knowledge in respect of the various ways, funds have been raised. In a similar manner,

information in respect of Applications or uses gives knowledge about the different ways in which the funds of the firm have been used. Firm may be able to plan future course of action with the information.

7. **Other Information:** Funds Flow Statement provides that information that is not precisely, available in the financial statements. If the firm purchases building and sells the same in the same accounting year for loss, the transaction does not appear in the Balance Sheet hence it would not be known. For this reason, Funds Flow Statement is always needed as a supplementary statement.

10.5 UTILITY OF FUNDS FLOW STATEMENT TO DIFFERENT PARTIES

The versatile utility of Funds Flow Statement to different parties can be summarised as follows:

1. **Management:** The historical Funds Flow Statement (Statements of the earlier years) provides the information how the funds were made available and their use in the past. They provide the means to understand why the targets of the earlier years were not achieved. That would be useful information to avoid recurrence, in future. Funds Flow Statements can be prepared for future too. Planning can be more effective with their help.

   Funds Flow Statements provide the necessary hints to the management, whether it is necessary for them to review and recast their plans, in a more realistic way, in case the future inflows are not adequate to meet the anticipated outflows.

2. **Financial Institutions:** Commercial banks require them to assess the working capital needs of the firm. Term-lending institutions want to satisfy the repayment capacity of the firm. Funds Flow Statement provides the information how the firm used the funds, earlier. Instances of diversion of sanctioned working capital for acquisition of fixed assets, contrary to the terms of sanction, would be known. The lenders would know firm's style of functioning.

   Instances are abundant, where working capital limits, sanctioned by banks, are used for purchase of luxurious cars and personal use. Funds Flow Statements show these types of diversion of funds.

The borrowings may be secured by the assets, but the financial institutions want to satisfy with the financial integrity of the borrower too. **Financial institutions would know the ways the funds were used, earlier, and future ways of use to judge their repaying ability.**

3. **Debenture holders:** Debenture holders too are long-term creditors of the firm. Their stake is similar to financial institutions. They would get back their money after several years, dependant on the maturity period of the debentures. **Funds Flow Statement shows the position of availability of funds, when the debentures fall due for repayment.** To continue to hold the debentures till such time or not, Funds Flow Statement is useful for them to take a suitable decision.

4. **Trade Creditors:** They are the suppliers of goods and services and look for short-term liquidity for payment. Liquidity of the firm and operating profits assure the repayment schedule. **Statement of Working Capital Position indicates how far the firm is liquid to meet the promised payment schedule to review their credit policy.**
5. **Shareholders:** Shareholders are, basically, interested about the financial position of the firm and their future investment plans that generate operating profits. This holds well to the existing as well as potential shareholders. **Future investment plans and the operating profits that are likely to generate would be known from the Funds Flow Statement.**

10.6 SOURCES OF FUNDS

The following are the sources through which funds come into the business of the firm.

1. **Funds from operations:** Profits from business is the main source of funds. Profit does not mean the amount that is shown in the profit and loss account. When profit and loss account is prepared, several operating and non-operating expenses are debited. Similarly, operating and non-operating incomes are also credited.

> **Non-operating item is one, which is not connected with the conduct of the business. Examples are loss on sale of assets, preliminary expenses written off and rent from building, not connected to the business.**

Adjustment is necessary to arrive at the correct profit from business operations. To arrive at operating income, non-operating expenses are to be added and non-operating income is to be deducted from the amount of profit shown in profit and loss account.

Profit from operations is the source as funds are received into the business.

2. **Sale of Fixed Assets:** If any fixed asset such as land, building, plant and machinery is sold, the total sale proceeds are a source. Sale of fixed assets increases the working capital. However, if one non-current asset (Fixed asset) is exchanged for another non-current asset, it does not constitute inflow/outflow of funds, as there is no change in working capital.
3. **Issue of Shares and Debentures:** When shares and debentures are issued to be public and cash is received, the amount of cash received is a source. The important point is, if cash is received then only it is a source. In the following instances, it is not to be treated as source:
   - (A) Issue of shares and debentures for consideration, other than current assets.
   - (B) Conversion of debentures and loans into shares.
   - (C) Issue of bonus shares or making partly paid shares as fully paid shares out of the accumulated profits.

   The reason is simple. Such above instances do not increase the working capital.
4. **Increase in Long-term Loans:** Long-term loans from financial institutions and banks are a source as they increase the availability of funds.

5. **Decrease in Working Capital:** If the working capital at the end of the period is decreased, compared to the amount at the beginning of the period, it is a source. This can happen due to reduction of current assets or increase of current liabilities. If stock Rs. 60,000 is reduced to Rs.40,000, working capital is decreased by Rs. 20,000 and the decrease is a source. Similarly, creditors may increase from Rs. 10,000 to Rs. 15,000 and the effect is reduction of working capital by Rs. 5,000. Decrease of working capital is a source of funds.
6. **Non-Trading Receipts:** Non-trading receipts like dividend and rent are also credited to profit and loss account. These items are deducted from the net profit to arrive at profit from business operations. So, these items are to be shown, separately, in the Funds Flow Statement, as they are also sources of funds, not included in the funds from operations.

10.7 IS DEPRECIATION A SOURCE OF FUNDS?

Depreciation means decrease in the value of an asset due to wear and tear, passage of time, obsolescence, exhaustion and accident**.** It is a part of capital cost of fixed asset, spread over the life of the asset. Depreciation is taken as an operating expense, while arriving at true profits of a business. Depreciation is, simply, a book entry to arrive at book profits. Depreciation is a non-cash item.

> **It is a myth, depreciation is a source. People misunderstand depreciation as a source as it is added to net profits to calculate funds from operations. Funds (Working capital or cash) are provided by revenues, but not by depreciation. Depreciation does not affect current assets or current liabilities. Preliminary expenses and goodwill written off are also added to net profits as these transactions do not result in any outflow of cash with them. The same treatment is extended to depreciation, while adding back to net profits to arrive at funds from operations.**

Depreciation is neither a direct source nor application of funds. **To quality to be a source, depreciation should increase quantum of working capital.** This is not happening. As depreciation is not decreasing working capital, it is also not an application of funds.

Another dimension, depreciation does not generate funds, but it saves funds. For example, if the firm takes the assets on hire, it has to pay rent for them. Payment of rent is avoided by owning assets, which would have resulted in the outflow of funds. So, ownership of assets has only saved funds, but not generated any new funds.

Depreciation is not a direct source of funds. Then, is it an indirect source of funds? The answer is both YES and NO. When it is an indirect source? If so, to what extent? These are the questions to be answered. Depreciation can be taken as an indirect source of funds, in a limited sense. It depends upon circumstances. If the firm is in profits, depreciation acts as a tax shield in helping the firm for reducing tax liability. Income tax permits depreciation as an admissible expenditure to the extent it is provided as per its rules. As a result, taxable profits are reduced and tax liability is reduced. So, to that extent, depreciation is a source.

> **Depreciation is a source to the extent tax liability is reduced. Due to depreciation, profits available for distribution of dividend gets reduced. But, more funds would be available to the business for expansion. In these circumstances, depreciation is a source. But, when the firm is in loss, question of tax payment does not rise. In those circumstances, depreciation is not a source.**

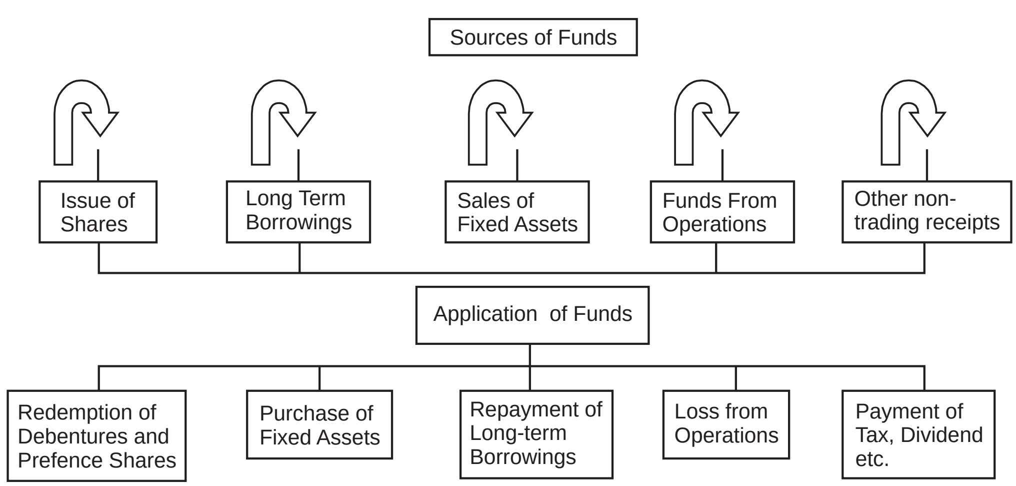
It can be said, with certainty, that depreciation is not a source of funds, directly. So, depreciation is only an indirect source to a limited extent, under certain circumstances.

> **Depreciation is an expense to be taken into account to arrive at accounting profit, but this has no relevance for calculation of funds from operations. For this reason, depreciation is added back to net profit to calculate funds from operations.**

The above point can be understood with a simple example:

	Case I (Rs.)	Case II (Rs.)
Income before depreciation	80,000	80,000
Depreciation provided (A)	----	20,000
Taxable income	80,000	60,000
Income Tax Rate, say 50%	40,000	30,000
Net income after tax (B)	40,000	30,000
Net flow of funds after tax (A+B)	40,000	50,000

In case of II, funds from operations are Rs. 50,000, while they are only Rs. 40,000 in case of I. In case of II, depreciation is a source to the extent of Rs. 10,000 and these funds are, additionally, available to the firm for future expansion.



Sources and Application of Funds

10.8 APPLICATION OR USES OF FUNDS

1. **Loss from Operations:** Result from trading operations may be loss in a year. Such loss of funds in trading amounts to an application or outflow of funds. Working capital would be the first casualty, if the firm sustains loss.
2. **Redemption of Preference Share Capital:** If preference shares are redeemed during a year, redemption decreases the funds and so it is an application. Where redemption happens at premium or discount, the net amount (including premium or after deducting discount) is the use. However, if preference shares are redeemed in exchange of some type of shares or debentures, it does not constitute outflow of funds as no fund is involved in the transaction.
3. **Repayment of loans or redemption of debentures:** Similar to redemption of preference shares, repayment of loan and redemption of debentures are also uses.
4. **Purchase of Fixed or non-current Asset:** Purchase of fixed assets such as machinery or building results in application of funds. However, purchase of fixed assets in consideration of issue of shares, debentures or loans is not use as no funds are involved.
5. **Payment of Dividend and Tax:** Payment of dividend (including interim dividend) and tax are applications. The important point is their actual payment, and then only they become uses. Mere declaration of dividend and provision of tax are not uses.
6. **Any other non-trading payments:** Any other non-trading payments are also uses as they involve outgo of funds. Examples are loss of cash or theft in business.

10.9 PROCEDURE FOR KNOWING WHETHER A TRANSACTION FINDS A PLACE IN FUNDS FLOW STATEMENT

1. Make out the journal entry and find out the accounts involved.
2. Decide whether the accounts concerned are current (concerned with current assets and current liabilities) or non-current (concerned with non-current assets and non-current liabilities).
3. If both the accounts involved are current i.e. either current assets or current liabilities, it does not result in the flow of funds.
4. If both the accounts are non-current, i.e. either permanent assets or permanent liabilities, the transaction still does not result in the flow of funds.
5. If one of the accounts is concerned with current and the other is non-current, the transaction results in flow of funds.

For the transaction to appear in Funds Flow Statement, it is necessary only one of the accounts in a transaction should be concerned with current assets or current liabilities. If both the accounts are current or non-current assets / liabilities, the transaction does not appear in Funds Flow Statement.

There is attraction between a male and female. In the normal course, there is no attraction between the specie of the same sex. In a similar manner, in a transaction, if both the accounts belong to the same category -current assets or liabilities - there is no funds flow. To appear in a Funds Flow Statement, one of the accounts only should belong to current assets / Current Liabilities.

Examples

Transaction	Journal Entry	Category of Debit Account	Category of Credit Account	Result- Flow of Funds or not-Reason
1. Cash collected from debtors	Cash A/c …Dr To Sundry Debtors	Current	Current	NO, Both the accounts are current assets. Cash increases with similar decrease in debtors.
2. Goods purchased for cash or credit	Purchases …Dr To Cash/Creditors A/c	Current	Current	NO, Both the accounts are current assets. Working capital remains same.
3. Purchase of machinery, in exchange of land	Machinery A/c …Dr To Land A/c	Non-Current	Non-Current	NO, Both the accounts are non-current assets. Does not affect working capital.
4. Transfer to General Reserves	Profit & Loss A/c ...Dr To General Reserves	Non-Current	Non-Current	NO. Does not affect working capital.
5. Issue of Debentures for cash	Cash A/c ... Dr To Debentures	Current	Non-Current	YES. One is current asset and another is non-current liability. Cash inflow increases working capital.
6. Redemption of Debentures	Debentures A/c …Dr To Cash	Non-Current	Current	YES. One is non-current

				liability and another is current asset. Cash outflow decreases working capital.
7. Purchase of Trade Investment	Trade Investment A/c.. Dr To Cash	Non-Current	Current	Yes. One is non-current asset and another is current asset. Cash outflow decreases working capital.
8. Writing off fictitious assets, say goodwill	Profit and Loss Account…Dr. To Goodwill Account	Non-Current	Non-Current	No. Both are non-current. Does not change working capital.

Illustration No. 1

State with reasons whether there is fund flow from that following transactions –

(a) Purchase of machine for cash Rs. 20,000.

(b) Sale of building Rs. 32,000. The original cost was Rs. 40,000 and accumulated depreciation was Rs. 24,000.

(c) 1,000 shares of Rs. 10 each issued at 11 per share;

(d) Goodwill written off out of profit Rs. 5,000;

(e) Rs. 6,000 declared as divided on equity shares and paid.

(B.U. M.B.A. 2007)

Solution:

Transaction	Journal Entry	Category of Debit Account	Category of Credit Account	Result- Flow of Funds or not-Reason
(a) Purchase of machinery for cash	Machinery A/c ..Dr 20,000 To Cash 20,000	Non-current	Current	Yes. One is non-current asset and the other is current asset. Decreases working capital by Rs. 20,000.

(b) Sale proceeds of building, at profit	Cash ….Dr. 32,000 To Building 32,000	Current	Non-Current	Yes. One is current asset and the other is non-current asset. Increases working capital by Rs. 32,000.
(c) Issue of shares, at premium	Cash …….Dr 11,000 To Share Capital 10,000 Share Premium 1,000	Current	Non-current Non-current	Yes. One is current and the other accounts are non-current. Increases working capital by Rs. 11,000
(d) Goodwill written from profit	Profit and Loss A/c. Dr 5,000 To Goodwill 5,000	Non - current	Non-current	No. Both the accounts are non-current. Does not change working capital.
(e) Dividend declared from profits on equity share capital	Profit and Loss A/c .Dr. 6,000 To Cash 6,000	Non - current	Current	Yes. One account is non-current and the other is current. Decreases working capital by Rs. 6,000.

Impact of Opening Stock / Closing Stock on Funds: Opening stock appears on the debit side of the Profit and Loss Account. Opening stock reduces profit, so it is an application. Closing stock appears on the credit side of the profit and loss account and also appears on the assets side of the balance sheet. Profit is a source. Due to closing stock, profit increases. So, closing stock is a source. More so, working capital increases, due to its inclusion in the current assets. This is also another argument why closing stock is a source.

10.10 PREPARATION OF FUNDS FLOW STATEMENT

To prepare Funds Flow Statement, two statements are required to be prepared. They are Statement of Changes in Working Capital and Statement of Funds from Operations. All the information may not be readily available, always. Hidden information has to be found out. The entire process of preparation of Funds Flow Statement can be summarised, as under:

(A) Statement of Changes in Working Capital
(B) Calculation of Funds from Operations
(C) Finding out hidden information, if required
(D) Preparation of Funds Flow Statement

(A) Statement of Changes in Working Capital

Working capital is the excess of current assets over current liabilities. Every current asset at the end of the year is to be compared with the amount at the beginning of the year to calculate the increase or decrease of working capital. Increase or decrease of working capital is to be recorded in the relevant column. The same procedure is to be repeated in respect of all current liabilities.

All other information is not relevant for preparation of Statement of Changes in Working Capital.

Working capital = Current Assets – Current Liabilities

Increase in Current Asset →	Increase in Working Capital
Decrease in Current Asset →	Decrease in Working Capital
Increase in Current Liability →	Decrease in Working Capital
Decrease in Current Liability →	Increase in Working Capital

Effect on working capital

Illustration No. 2

Prepare a Statement of Changes in Working Capital from the following Balance Sheets of THEER & LTD. Bhopal.

	31st March, 2006	**31st March, 2005**
Assets		
Goodwill	20,000	15,000
Bank	70,000	60,000
Debtors	40,000	45,000
Bills Receivable	10,000	8,000
Closing Stock	20,000	22,000
Long-term Investments	5,000	3,000
Building	25,000	15,000
Preliminary Expenses	4,000	6,000
	1,94,000	**1,74,000**
Liabilities		
Trade Creditors	55,000	60,000
Bills Payable	30,000	25,000

Loans (Payable during 2007- Rs. 25,000)	40,000	-------
Equity Share Capital	50,000	80,000
Profit & Loss Account	19,000	9,000
	1,94,000	**1,74,000**

Solution:

Statement of Changes in Working Capital

Particulars	2005	2006	Effect on Working Capital Increase Rs.	Decrease Rs.
Current Assets:				
Bank	60,000	70,000	10,000	
Debtors	45,000	40,000		5,000
Bills Receivable	8,000	10,000	2,000	
Closing Stock	22,000	20,000		2,000
	1,35,000	**1,40,000**		
Current Liabilities:				
Trade Creditors	60,000	55,000	5,000	
Bills Payable	25,000	30,000		5,000
*Loans (Payable during 2007)	------	25,000		25,000
	85,000	**1,10,000**		
Working Capital (CA-CL) Decrease in Working Capital	50,000	30,000 20,000	20,000	
	50,000	50,000	37,000	37,000

*** Note:** Out of the total Loan amount Rs. 40,000, only Rs.25,000 is repayable during the year 2007. Only Rs. 25,000 is current liability, as it becomes payable within one year and so working capital is affected to that extent only.

(B) Calculation of Funds from Operations

The net profit seen in the Profit and Loss Account need not necessarily be the funds from operations. Certain adjustments are to be made to get Funds from Operations. Follow the steps as under:

1. Take the net profit figure in Profit and Loss Account as the **BASE**.

2. **Depreciation:** Add back depreciation to the net profit, debited in the Profit and Loss Account, as it does not involve outflow of funds. Depreciation is an expense to be taken into account to arrive at accounting profit, but this has no relevance for calculation of funds from operations.
3. **Intangible Assets written off:** Add back expenses like preliminary expenses, discount on issue of shares and debentures, goodwill written off. These are intangible assets written off to arrive at profit, but does not involve outflow of funds.
4. **Incomes not related to Operations or Business:** These are the incomes that are not related to operations but included in Profit and Loss Account to arrive at net profit. These incomes – profit on sale of assets, income from investments and rent from buildings, not connected to business – are to be deducted from net profits.
5. **Non-operating Expenses:** Similarly, non-operating expenses like loss on sale of assets, loss due to theft debited to Profit and Loss Account are to be added back to net profit to arrive at Funds from Operations.

The intention of the exercise is to find out funds from operations. Instead of net profit, net loss may appear in Profit and Loss Account. Simply, follow a reverse procedure to arrive at funds from operations, in case loss is in Profit and Loss Account. This easy procedure is suggested for students who experience difficulty in appreciating the implication.

Income Statement or Profit and Loss Account is not given: If Income Statement or Profit and Loss Account is not given, information on net profit or loss may be, indirectly, given. Increase in General Reserve and Profit and Loss Accounts, balances appearing between opening and closing balance sheets, have to be taken as net profit for the period. Suitable adjustments are to be made for the dividend paid and issue of bonus shares, capitalising profits. Funds from operations can be calculated by preparing Profit and Loss Adjustment Account.

Funds Flow Statement can be prepared in two types:

1. Report Form
2. T Form or Account Form or Self-Balancing Type.

Illustration No. 3

From the following information, extracted from the Balance Sheets of Theer & Tarkh Ltd., calculate Funds from Operations:

	As on 31st March,2005 (Rs.)	**As on 31st March,2006 (Rs.)**
Share Capital	80,000	1,00,000
General Reserve	30,000	35,000
Profit and Loss Account	40,000	1,00,000
Depreciation Fund	15,000	18,000
Goodwill	15,000	10,000
Preliminary Expenses	3,000	2,000
Patents	10,000	8,000

Bonus shares have been issued for Rs.20,000 during 2005-06, capitalising profits from Profit and Loss Account. It is observed in the Profit and Loss Account that an income from sale of machinery Rs.6,000 has been received.

Solution:

	Rs.
Profit and Loss Account (as on 31st March, 2006) – closing Balance	1,00,000
+ Increase in share capital (Bonus issue)	
Transferring from Profit and Loss A/c	20,000
+ Transfer to General Reserve	5,000
+ Provision for Depreciation	3,000
+ Goodwill written off	5,000
+ Preliminary Expenses written off	1,000
+ Patents written off	2,000
– Income from sale of machinery	6,000
	1,30,000
– Balance in Profit and Loss Account – opening balance	40,000
(As on 31st March, 2005)	
Funds from Operations	90,000

The funds from operations can be found out in an alternative way by preparing Profit and Loss Adjustment Account.

Dr. Adjusted Profit and Loss Account Cr.

Particulars	Amount	Particulars	Amount
To Transfer to Capital Account (Bonus issue)	20,000	By Balance b/d	40,000
		By Income from sale of machinery	6,000
To Transfer to General Reserve	5,000	By Funds from Operations	90,000
To Depreciation Fund (Provision for Depreciation)	3,000		
To Goodwill written off	5,000		
To Preliminary Expenses written off	1,000		

To Patents Written off	2,000		
To Balance c/d	1,00,000		
	1,36,000		1,36,000

(C) Finding out hidden information

While preparing the Funds Flow Statement, one has to analyse the Balance Sheets given. At the end of balance sheets, certain information may be given as notes that give clues for the hidden information. The hidden information may relate to provision and payment of tax, purchase/ sale of assets and issue/ redemption of shares and debentures.

1. **Provision for Taxation:** There are two ways of dealing with provision for Taxation.
   - (i) As a current liability
   - (ii) As an appropriation of profit
   - **(i) As a current liability:** Provision for tax may be treated as current liability as tax, generally, is an immediate obligation of the firm to pay to the Government.

It is preferable to treat 'Provision of tax' as current liability as such treatment is simple as nothing, further, is to be done. This approach is recommended for students, if the problem does not stipulate any specific treatment.

When it is treated as current liability, provision for taxation will appear in the Schedule of Changes in Working Capital, like other current liabilities. No further treatment is needed in respect of payment of tax and provision of tax made during the year. There is no need to prepare provision for taxation account. The simple rules are as under:

(i) In this case, payment of tax shall not be shown as an application of funds.

(ii) Provision for tax made during the year is not to be added back to the profits to arrive at funds from operations.

The simple rule is to treat provision for tax as current liability and forget further treatment about this matter.

(ii) As an appropriation of Profit: When provision for tax is treated as an appropriation of profit, follow the treatment as under:

(A) Do not treat 'Provision for tax' as current liability for working capital calculation. In other words, do not include in 'Schedule of changes in Working Capital'.

(B) Show the payment of tax as Application in 'Funds Flow Statement'.

(C) Add back 'provision made for tax' in the current year to the current year's profit to get the operating profit.

So, information for tax payment and provision made for tax in the current year is necessary.

Illustration No. 4

The opening balance in the Provision for Taxation Account as on 1st January 2005 was Rs. 40,000 and the closing balance as on 31st December 2005 was Rs. 50,000. The taxes paid during the year amounted to Rs. 35,000. Show the treatment of the item in the Funds Flow Statement:

(i) As Current Liability

(ii) As Appropriation of Profit

Solution:

(i) When provision for taxation is treated as Current liability

Provision for taxation is treated as current liability and is shown in the schedule of changes in working capital. No further effect on the Funds Flow Statement:

Schedule of Changes in Working Capital

	1-1-2005 Rs.	31-12-2005 Rs.	Increase in Working Capital Rs.	Decrease in Working Capital Rs.
Current Liabilities				
Provision for Taxation	40,000	50,000		10,000

(ii) As Appropriation of Profit:

1. This item will not be shown in the Schedule of Changes in Working Capital.
2. Taxes paid during the year Rs. 35,000 is an Application of Funds and will appear on the application side of Funds Flow Statement.

Funds Flow Statement
for the year ended 31-12-2005

Sources	Rs.	Application	Rs.
		Payment of Tax	35,000

3. Provision for taxation made during the year Rs. 45,000 is calculated as below. This amount will be added back to net profit for finding Funds from Operations.

Calculation of Provision for Taxation made during the year

Opening balance of Provision for tax on 1-1-2005	40,000
Less : Tax paid during the year	35,000
	5,000
Closing balance of Provision on 31-12-2005	50,000
Provision made during the year	45,000

or

Dr. Provision for Taxation A/c Cr.

To Cash (tax paid)	35,000	By Balance b/d	40,000
To Balance c/d	50,000	By Adjusted P/LA/c (Provision made-Balancing figure)	45,000
	85,000		85,000

Note: It is suggested to students to adopt 'Prepare Account' approach to find out the hidden information so that double entry concept can be applied, conveniently. More so, account preparation leaves no confusion about adding or subtracting the figures.

Proposed Dividend

Treatment of Proposed Dividend is similar to Provision for Taxation.

Proposed dividend can be treated as current liability or appropriation of profits.

(i) As Current Liability: Dividend recommended for payment by Board of Directors is, normally, approved for payment at Annual General Meeting. Till it is approved, it is appropriation of profits and after approval, it is an obligation on the part of company to make payment, so it is a current liability. **Students are advised to treat the amount of proposed dividend as current liability as the treatment is simple.** Show the amount as current liability in the Schedule of Changes in Working Capital. Information in respect of provision and its payment are to be ignored. Provision should not be added back to the net profits and payment should not be shown in application.

(ii) As non-current Liability: As proposed dividend is an appropriation of profit, it is not a current liability. Hence, the amount is not to be included in the Schedule of Changes in Working Capital. The appropriation of dividend, made during the year, is to be added back to net profits to calculate funds from operations. Actual dividend payment is to be shown as application in Funds Flow Statement.

Treatment of Proposed Dividend is similar to provision for Taxation.

Interim Dividend: The expression 'Interim dividend' denotes dividend paid to shareholders of the company during the financial year, before the finalisation of accounts. This is the dividend paid or declared between two Annual General Meetings. Interim dividend should be added back to the figure of net profits (or debited to Profit and Loss Adjustment Account) to arrive at Funds from Operations. However, if the closing balance in the profit and loss account is given after payment of interim dividend, this adjustment is not required. To ascertain whether the closing balance in the Profit and Loss Account is after or before payment of interim dividend, it is desirable to prepare the Profit and Loss Account and incorporate the adjustments to find out the picture. Interim dividend is to be shown as an Application of funds.

Illustration No. 5

From the following Balance Sheets as on 31st March, 2005 and 31st March, 2006, prepare a Schedule of Changes in the Working Capital and Funds Flow Statement taking:

(i) the provision for tax and proposed dividend as current liabilities and

(ii) the provision for tax and proposed dividend as non-current liabilities.

BALANCE SHEET

Liabilities	31-12-2005	31-12-2006	Assets	31-12-2005	31-12-2006
	Rs.	Rs.		Rs.	Rs.
Share Capital	1,00,000	1,50,000	Fixed Assets	1,00,000	1,55,000
Profit and Loss Account	4,000	6,000	Current Assets	13,000	14,500
Provision for tax	2,000	3,000			
Proposed Dividends	1,000	1,500			
Sundry Creditors	4,000	6,000			
Outstanding expenses	2,000	3,000			
	1,13,000	1,69,500		1,13,000	1,69,500

Additional information:

1. Tax paid during 2006 Rs.2,500
2. Dividends paid during 2006 Rs.1,000

Solution:

(i) When provision for tax and proposed dividends are taken as current liabilities.

Schedule of Changes in Working Capital

			Effect on Working capital	
Particulars	**31-12-2005**	**31-12-2006**	**Increase(+) Rs.**	**Decrease(–) Rs.**
Current Assets	13,000	14,500	1,500	
Current Liabilities				

Sundry creditors	4,000	6,000		2,000
Outstanding expenses	2,000	3,000		1,000
Provision for tax	2,000	3,000		1,000
Proposed Dividends	1,000	1,500		500
Total Current Liabilities	9,000	13,500		
Net Working Capital (CA- CL)	4,000	1,000		
Decrease in Working Capital		3,000	3,000	
	4,000	4,000	4,500	4,500

Funds Flow Statement
for the year ended 31-12-2006

Sources	Rs.	Application	Rs.
Increase in share capital	50,000	Purchase of Fixed Assets	55,000
Funds from operations	2,000		
Decrease in Working Capital	3,000		
	55,000		55,000

(ii) When provision for tax and proposed dividends are taken as non-current liabilities:

Schedule of Changes in Working Capital

			Effect on Working capital	
Particulars	**31-12-2005**	**31-12-2006**	**Increase(+) Rs.**	**Decrease(–) Rs.**
Current Assets	13,000	14,500	1,500	
Current Liabilities				
Sundry creditors	4,000	6,000		2,000
Outstanding expenses	2,000	3,000		1,000
Total Current Liabilities	6,000	9,000		

Net Working Capital (CA- CL)	7,000	5,500		
Decrease in Working Capital		1,500	1,500	
	7,000	7,000	3,000	3,000

Provision for Tax

Dr. **Cr.**

To Cash (Tax Paid)	2,500	By Balance b/d	2,000
To Balance c/d	3,000	By P & L Adjustment A/c (Balancing figure)	3,500
	5,500		5,500

Profit and Loss Adjustment Account

Dr. **Cr.**

To Provision for Tax	3,500	By Balance b/d	4,000
To Proposed Dividend	1,500	By Funds from Operations (Balancing figure)	7,000
To Balance b/d	6,000		
	11,000		11,000

Proposed Dividend Account

Dr. **Cr.**

To Cash	1,000	By Balance b/d	1,000
To Balance c/d	1,500	By Profit and Loss Adjustment A/c	1,500
			2,500
	2,500		

Funds Flow Statement
for the year ended 31-12-2006

Sources	**Rs.**	**Application**	**Rs.**
Increase in share capital	50,000	Purchase of Fixed Assets	55,000
Funds from operations	7,000	Tax Paid	2,500
Decrease in Working Capital	1,500	Dividend Paid	1,000
	58,500		58,500

Illustration No. 6

The comparative Balance Sheets Kalyan & Kishore Ltd are indicated in a condensed form as under:

Liabilities	31-3-06	31-3-05	Assets	31-3-06	31-3-05
	Rs.	Rs.		Rs.	Rs.
Share Capital	4,00000	3,60,000	Fixed Assets	5,20,000	4,80,000
General Reserve	60,000	1,10,000	Less: Depreciation	1,40,000	1,08,000
Profit & Loss Account	53,450	20,450		3,80,000	3,72,000
Sundry Creditors	1,75,350	1,83,650	Investments	50,000	1,00,000
Proposed Dividend	15,000	28,800	Debtors	1,67,800	1,18,300
Provision for Tax	32,000	--------	Stock	90,500	55,600
			Bank Balance	47,500	49,800
			Preliminary Expenses	-------	7,200
	7,35,800	7,02,900		7,35,800	7,02,900

Additional information:

1. The net profit for the year 2005-06 (after providing depreciation Rs. 40,000, writing off preliminary expenses of Rs. 7,200 and making provision for tax Rs.32,000) amounted to Rs.58,000.
2. The company sold during the year, an old machinery costing Rs. 9,000 for Rs. 3,000. The accumulated depreciation on the said machinery was Rs. 8,000.
3. A portion of company's investments became worthless and was written off to General Reserve during the year. The cost of such investment was Rs. 50,000.
4. During the year, the company paid an interim dividend of Rs. 10,000 and the directors have recommended final dividend of Rs. 15,000 for the current year.

Treat proposed dividend as non-current liability and prepare the Schedule of Change in Working Capital and the Funds Flow Statement.

Solution:

Schedule of Change in Working Capital

Particulars	As on 31-3-2005	As on 31-3-2006	Increase in Working Capital	Decrease in Working Capital
Current Assets				
Debtors	1,18,300	1,67,800	49,500	
Stock	55,600	90,500	34,900	
Bank Balance	49,800	47,500		2,300
Total Current Assets	2,23,700	3,05,800		
Current Liabilities				
Creditors	1,83,650	1,75,350	8,300	
Total Current Liabilities	1,83,650	1,75,350		
Working Capital (CA-CL)	40,050	1,30,450		
Net Increase in Working Capital	**90,400**			**90,400**
	1,30,450	**1,30,450**	**92,700**	**92,700**

Dr. Fixed Assets Account Cr.

To opening Balance b/d	4,80,000	By Sale of Old Machinery Account	9,000
To Cash- Purchase of Assets (Balancing figure)	49,000	By Closing Balance c/d	5,20,000
	5,29,000		5,29,000

Dr. Sale of Old Machinery Account Cr.

To Fixed Assets Account	9,000	By Cash (Sale Amount)	3,000
To Profit on sale of Machinery	2,000	By Depreciation Account	8,000
	11,000		11,000

Dr. Depreciation Account Cr.

To Old Machinery Account	8,000	By Opening Balance b/d	1,08,000
To Closing Balance c/d	1,40,000	By Depreciation for the year	40,000
	1,48,000		1,48,000

Dr. Profit and Loss Adjustment Account Cr.

To Proposed Dividend (2006)	15,000	By Opening Balance	20,450
To Interim Dividend paid	10,000	By Net Profit for the year	58,000
To Closing Balance	53,450		
	78,450		78,450

Funds from Operations

Net Profit for the year 1998	58,000	
Add:		
Depreciation	40,000	
Preliminary Expenses written off	7,200	
Provision for Tax	32,000	1,37,200
Less :		
Profit on Sale of Machinery		2,000
Funds from Operations		**1,35,200**

Source & Application of Funds

Sources	**Rs.**	**Application**	**Rs.**
Sale of old Machinery	3,000	Purchase of Assets	49,000
Funds from Operations	1,35,200	Payment of Dividends:	
Issue of Share Capital	40,000	Interim Dividend	10,000
		Final Dividend	28,800
		Increase in Working Capital	90,400
	1,78,200		1,78,200

Note:

1. Profit and Loss Adjustment Account has been prepared to show that interim dividend and proposed dividend for the year 2006 have been appropriated.
2. The balance in the profit and loss account at the end of 2006 is after payment of interim dividend and provision for proposed dividend for the year 2006. To confirm that the closing balance in the Profit and Loss Account is after payment of interim dividend, Profit and Loss Adjustment Account is prepared and the adjustments have been incorporated.

Illustration No. 7

The following information has been taken from the Balance Sheet of Tarkh & Company, Indore.

	31st March, 2005 Rs.	31st March, 2006 Rs.
Machinery	1,00,000	2,70,000
Accumulated Depreciation	45,000	60,000
Profit and Loss Account	15,000	40,000

The following additional information is also available:

(i) A machine costing Rs. 15,000 was purchased during the year by issue of equity shares.

(ii) On January 1st 2005, a machine costing Rs. 25,000 (with an accumulated depreciation of Rs. 10,000) was sold for Rs. 22,000.

Find out sources/application of funds.

Solution:

Dr. Machinery Account Cr.

	Rs.		Rs.
To Balance b/d	1,00,000	By Sale of machinery A/c	25,000
To Share Capital	15,000		
To Cash- Purchase of machinery (Balancing figure)	1,80,000	By balance c/d	2,70,000
	2,95,000		2,95,000

Dr. Accumulated Depreciation A/c Cr.

	Rs.		Rs.
To Sale of Machinery A/c	10,000	By Balance b/d	45,000
To Balance c/d	60,000	By Adjusted P/L A/c (Balancing figure)	25,000**
	70,000		70,000

Dr. Sale of Machinery Account Cr.

To Machinery Account	25,000	By Depreciation	10,000
To Profit and Loss Adjustment Account	7,000	By Cash (sale of machinery)	22,000
	32,000		32,000

Dr. Adjusted Profit and Loss Account Cr.

	Rs.		Rs.
To Accumulated Depreciation A/c	25,000**	By Balance b/d	15,000
To Balance c/d	40,000	By sale of Machinery A/c (Profit on sale)	7,000
		By Funds from Operations	43,000
	65,000		65,000

**** represents deprecation provided during the year**

1. Purchase of Machinery for Rs.15,000 by issue of equity shares is neither a source nor an application of funds.
2. Sale of Machinery Rs. 22,000 is a source of funds.
3. Funds from Operations Rs. 43,000 are a source of funds.
4. Purchase of machinery by cash Rs. 1,80,000 is an Application of funds.

Illustration No. 8

The following relevant information has been extracted from the following Balance Sheets:

	As on 31st December, 2005 Rs.	As on 31st December, 2006 Rs.
Equity Share Capital	6,00,000	10,00,000
Preference Share Capital	3,00,000	4,50,000

Additional Information:

1. Equity shares were issued during the year for purchase of Building for Rs. 2,50,000.
2. 9% Preference Share Capital value Rs. 1,75,000 was redeemed during the year.

Prepare necessary accounts to find out Source/Application of Funds.

Solution:

Dr. Equity Share Capital Account Cr.

	Rs.		Rs.
To Balance c/d	10,00,000	By Balance b/d	6,00,000
		By Building A/c	2,50,000
		By Cash (Issue of shares-Balancing figure)	1,50,000
	10,00,000		10,00,000

Dr. 9% Preference Share Capital Account Cr.

	Rs.		Rs.
To Cash (Redemption of shares)	1,75,000	By Balance b/d	3,00,000
To Balance c/d	4,50,000	By Cash (Issue of shares-Balancing figure)	3,25,000
	6,25,000		6,25,000

1. Issue of Equity Shares against purchase of Building Rs. 2,50,000 is neither a source nor application of funds. Issue of shares for Rs. 1,50,000 is a source.
2. Redemption of Preference Shares Rs. 1,75,000 is an application of funds.
3. Issue of Preference Shares Rs. 3,25,000 is a source of funds.

Issue of Shares, other than cash: If shares are issued for cash, proceeds from issue of shares are a source. If shares are issued for acquiring non-current assets like fixed assets, the transaction is totally ignored, as the transaction does not appear, anywhere, in Sources and Application of Funds. However, the typical question comes when shares are issued for acquiring current assets as well as non-current assets, how the transaction is to be presented? Total value of the amount of shares issued is to be shown as a source. The current assets acquired increase working capital and the increased working capital is shown as application of funds. The non-current assets acquired too are to be shown as application.

The following problem explains the method of presentation.

Illustration No. 9

Prepare Statement Showing Changes in Working Capital and Source & Application of Funds from the following information:

	March,2005	March,2006
Creditors	1,40,000	1,30,000
Bills payable	40,000	30,000

Bank overdraft	50,000	----
Income Tax provision	75,000	65,000
Reserves	80,000	80,000
P & L Account	84,000	28,000
Share capital	5,00,000	6,00,000
	9,69,000	**9,33,000**
Cash in hand	50,000	70,000
Cash at bank	1,00,000	1,20,000
Debtors	1,65,000	1,00,000
Prepaid expenses	4,000	3,000
Stock	1,50,000	1,00,000
Fixed assets	5,00,000	4,80,000
Goodwill	----	60,000
	9,69,000	**9,33,000**

The following information was obtained:

(i) In 2006, a dividend of Rs. 84,000 was paid.

(ii) Assets of another firm were purchased at Rs. 1,00,000, payable in 10,000 shares of Rs. 10 each. The assets included stock Rs. 10,000; fixed assets Rs. 30,000; and goodwill Rs. 60,000.

(iii) Income tax paid in 2006 was Rs. 10,000.

(iv) Net profit in 2006 was Rs. 28,000.

Solution:

Statement Showing Changes In Working Capital

	As on 31.3.05	**As on 31.3.06**	**Increase in Working Capital**	**Decrease in Working Capital**
Current Assets:				
Stock	1,50,000	1,00,000		50,000
Debtors	1,65,000	1,00,000		65,000
Cash in hand	50,000	70,000	20,000	
Cash at bank	1,00,000	1,20,000	20,000	
Prepaid expenses	4,000	3,000		1,000
	4,69,000	3,93,000		

Current Liabilities				
Creditors	1,40,000	1,30,000	10,000	
Bills payable	40,000	30,000	10,000	
Bills overdraft	50,000	--	50,000	
Income-tax provision	75,000	65,000	10,000	
	3,05,000	2,25,000		
Working capital	1,64,000	1,68,000		
Increase in working Capital	4,000			4,000
	1,68,000	1,68,000	1,20,000	1,20,000

Dr. Fixed Assets Account Cr.

To Opening Balance	5,00,000	By Depreciation (Balancing figure)	50,000
To Additions	30,000	By Balance c/d	4,80,000
	5,30,000		5,30,000

Dr. Income Tax Provision Account Cr.

To cash	10,000	By Balance b/d	75,000
To Balance c/d	65,000		
	75,000		75,000

Funds from Operations (Rs.)

Net Profits	28,000
Add : Depreciation	50,000
Funds from Operations	78,000

Statement of Sources and Application of Funds

Sources	Rs.	Application	Rs.
Funds from Operations	78,000	Increase in Fixed Assets	30,000
Issue of Shares	1,00,000*	Goodwill	60,000
		Cash Dividends	84,000
		Increase in working capital	4,000
	1,78,000		1,78,000

Note: Balance in Profit and Loss Account at the end of 31st March, 2005 is Rs. 84,000. The amount is totally paid as dividend, hence shown as Application. There is no balance left out for the previous year's profit. Net Profit for the year 2006 is Rs. 28,000 , which is the balance in the Profit and Loss Account at the end of March, 2006.

***This represents the total value of shares acquired in consideration of stock Rs. 10,000 included the current assets shown in Schedule of Changes in Working Capital and non-current assets acquired shown as application.**

Tip to Students: When shares are issued for acquiring current and non-current assets, the whole transaction has to be taken.

Treatment of Investments

Investments: Treatment of investments depends on the nature of investments purchased. i.e. current assets or fixed assets. They can be temporary investments or permanent investments.

Temporary Investments: When a firm has temporary excess funds, it is normal to purchase temporary investments. They are to be treated as current assets. They find a place in Schedule of Changes in Working Capital and they are to be treated like any other current assets. Just like any other current assets, they do not appear in Funds Flow Statement. **Dividend received on such investments is treated like business income.** Loss/profit on sale of such investments is like any other business loss/profit and is to be shown in Profit and Loss Account. If the amount is credited to Profit and Loss Account, it does not appear in Profit and Loss Adjustment account, again, as no adjustment is needed.

Long-term or non-current, Trade Investments: They are to be treated like fixed assets or non-current assets. As they are not current assets, they should not appear in the Schedule of Changes in Working Capital. If investments are purchased on the basis of 'cum-dividend', pre-acquisition dividend as and when received, subsequently, is to be credited to Trade Investment Account. Reason is the price of investments, paid, includes the amount of dividend, to be received later. Here, dividend has been declared and the due date for receipt of dividend has not yet lapsed. Investments are to appear at cost. For this reason, dividend declared but not received is to be credited to the Investment Account. Investment Account has to be prepared to find out investments purchased or sold and profit/loss on sale/purchase of investment, if any.

Purchase of investment is to be treated as Application and sale as a source of funds. **Dividend received on these investments is not normal business income and is not to be credited to Profit and Loss Account.** This dividend amount is to be deduced from net profit to arrive at funds from operations. In case dividend is credited, the amount should be credited to Profit and Loss Adjustment Account to arrive at funds from operations.

The following problem explains the treatment of trade investments (fixed asset or non-current asset).

Illustration No. 10

From the following balance sheets of Beta Limited, make out

(i) Statement of changes in Working capital and

(ii) Funds Flow Statement:

BALANCE SHEETS

Liabilities	2001	2002	Assets	2001	2002
	(Rs.)	(Rs.)		(Rs.)	(Rs.)
Equity Share Capital	3,00,000	4,00,000	Goodwill	1,00,000	80,000
8% Redeemable Preference Share Capital	1,50,000	1,00,000	Land&Building	2,00,000	1,70,000
Capital Reserve	-	20,000	Plant	80,000	2,00,000
General Reserve	40,000	50,000	Investments	20,000	30,000
Profit & Loss Account	30,000	48,000	Sundry Debtors	1,40,000	1,70,000
Proposed Dividend	42,000	50,000	Stock	77,000	1,09,000
Sundry Creditors	25,000	47,000	Bills Receivable	20,000	30,000
Bills Payable	20,000	16,000	Cash in hand	15,000	10,000
Liabilities for Expenses	30,000	36,000	Cash at Bank	10,000	8,000
Provision for Taxation	40,000	50,000	Preliminary Expenses	15,000	10,000
	6,77,000	8,17,000		6,77,000	8,17,000

Notes:

1. A piece of land has been sold out in the year 2002 and profits on sales have been carried to capital Reserve.
2. A machine has been sold for Rs.10,000. The written down value of the machine was Rs.12,000. Depreciation of Rs.10,000 is charged on plant account in the year 2002.
3. The investments are trade investments. Rs. 3,000 by way of dividend is received including Rs.1,000 from pre-acquisition of profit, which had been credited to investments account.
4. An interim dividend of Rs.20,000 has been paid in the year 2002.

(M.B.A. –B.U., Bhopal 2003)

Statement of changes in Working capital

Particulars	2001	2002	Increase in Working Capital	Decrease in Working Capital
Current Assets				
Sundry Debtors	1,40,000	1,70,000	30,000	
Stock	77,000	1,09,000	32,000	

Bills Receivable	20,000	30,000	10,000	
Cash in hand	15,000	10,000		5,000
Cash at Bank	10,000	8,000		2,000
	2,62,000	3,27,000		
Current Liabilities				
Sundry Creditors	25,000	47,000		22,000
Bills Payable	20,000	16,000	4,000	
Liabilities for Expenses	30,000	36,000		6,000
Provision for Taxation	40,000	50,000		10,000
	1,15,000	1,49,000		
Working Capital	1,47,000	1,78,000	76,000	45,000
Increase in Working Capital	**31,000**			**31,000**
	1,78,000	1,78,000	76,000	76,000

Dr. **Trade Investments Account** **Cr.**

To Opening Balance b/d	20,000	By Dividend received (credited to this account)	1,000
To Purchase of Investments	11,000	By Closing Balance c/d	30,000
(Balancing figure)	31,000		31,000

Dr. **Plant Account** **Cr.**

To Balance b/d	80,000	By Depreciation	10,000
		By Cash (Sale of machine)	10,000
To Machinery Purchased (Balancing)	1,42,000	By Loss on sale of Machine	2,000
		By Balance c/d	2,00,000
	2,22,000		2,22,000

Proposed Dividend Account

Dr.			Cr.
To Cash (Payment of dividend)	42,000	By Balance b/d	42,000
To Balance c/d	50,000	By Profit and Loss Account	50,000
	92,000		92,000

Adjusted Profit and Loss Account

Dr.			Cr.
To General Reserve	10,000	By Balance	30,000
To Depreciation	10,000	By Dividend on Trade Investments	2,000
To Interim dividend	20,000	By Funds from Operations	1,33,000
To Loss on sale of machine	2,000		
To Preliminary expenses written off	5,000		
To Proposed Dividend Account	50,000		
To Goodwill Written off	20,000		
To Balance	48,000		
	1,65,000		1,65,000

Sources and Application of Funds

Sources	Rs.	Applications	Rs.
Sale of Land	50,000	Increase in Working Capital	31,000
Funds from Operations	1,33,000	Payment of Dividend	42,000
Sale of machine	10,000	Interim dividend paid	20,000
Dividend on Trade Investments	3,000	Redemption of 8% Redeemable Preference Shares	50,000
Issue of Equity Shares	1,00,000	Purchase of Machinery	1,42,000
		Purchase of Trade Investments	11,000
	2,96,000		2,96,000

Note:

1. Dividend received on Trade Investments is Rs.3,000. Out of Rs.3,000, only Rs.1,000 has been credited to Trade Investments Account. The balance amount Rs.2,000 has been credited to Profit and Loss Account. This is the interpretation of the problem. Many think Rs. 3,000 totally has been credited to Trade Investments Account. But, this is not so. Many a time, students' loose full marks, as answer would be different for incorrect interpretation.
2. The second part is reasoning for crediting part of dividend to Trade Investments Account. When trade investment is purchased on the basis of 'cum dividend', pre-acquisition dividend, subsequently received, is to be credited to Investment Account, as investment should appear at cost only.
3. Dividend received on investments (Fixed assets, non-current assets) is not operating income and so it is to be shown in Profit and Loss Adjustment account for calculating funds from operations. In other words, dividend is not part of normal business income.
4. Proposed Dividend has not been treated as current liability. It has been treated as appropriation of profit for better presentation. Interim dividend has been shown in application as the amount has been paid during the year. Another alternative way is to show proposed dividend as current liability. In that event, both proposed and interim dividends are not to be shown as application.

Revaluation of Fixed Assets

Sometimes fixed assets are revalued and profit or loss on such revalued assets is transferred to Profit and Loss Account. Such change in the value of fixed assets is neither inflow nor outflow of funds.

At times, the profit on revaluation of the fixed asset may be credited to Capital Reserve Account. There is no inflow or outflow of funds as both the accounts are non-current. So, the transaction does not appear in Source and Application of Funds.

The following illustration explains the presentation.

Illustration No. 11

In the following Balance Sheet, a part of machinery costing Rs.20,000 has been revalued at Rs.30,000 and transferred to Profit and Loss Account. Show the necessary accounts.

Liabilities	2005	2006	Assets	2005	2006
			Machinery	1,50,000	2,50,000

Solution:

Profit and Loss Adjustment Account

Dr. **Cr.**

		By Machinery Account (Profit on Revaluation of Machinery)	10,000

Machinery Account

To Balance b/d	1,50,000		
To Profit and Loss Adjustment Account (Profit on Revaluation of Machinery)	10,000		
To cash- Purchase of machinery (Balancing figure)	90,000	By Balance c/d	2,50,000
	2,50,000		2,50,000

Funds Flow Statement

Sources		Applications	
		Purchase of Machinery	90,000

Redemption of Debentures by issue of Shares: If debentures are redeemed by cash, redemption of debentures is to be shown as application of funds. Instead of redeeming by cash, shares may be issued for redemption of debentures. As both the items are non-current, neither issue of shares nor redemption of debentures appears in Source and Application of Funds.

Illustration No.12

You are given the Balance Sheets of Sandhya & Co. as at the end of 2005 and 2006 as under:

Liabilities	2005 Rs.	2006 Rs.	Assets	2005 Rs.	2006 Rs.
Equity Share Capital	2,00,000	2,50,000	Building	2,00,000	2,00,000
Share Premium	----	5,000	Plant at cost	1,04,000	1,00,000
General Reserve	50,000	60,000	Furniture at cost	7,000	9,000
Profit & Loss Account	10,000	17,000	Investments at cost	60,000	80,000
8% Debentures	70,000	50,000	Debtors	30,000	70,000
Provision for depreciation on plant	50,000	56,000	Stock	60,000	65,000
Provision for depreciation on furniture	5,000	6,000	Cash	30,000	45,000
Provision for taxation	20,000	30,000			
Sundry Creditors	86,000	95,000			
	4,91,000	5,69,000		4,91,000	5,69,000

Equity shares were issued, at par, for redemption of debentures. A dividend of 10% on share capital, at the end of the year, was paid.

A plant purchased for Rs. 4,000 (Depreciation Rs. 2,000) was sold for cash for Rs. 800 during the year. An item of furniture was purchased for Rs. 2,000. These were the only transactions concerning fixed assets during 2006.

Treat Provision for Tax as non-current liability.

Prepare Schedule of Changes in Working Capital and Funds Flow Statement.

Solution:

SCHEDULE OF CHANGES IN WORKING CAPITAL

	2005	2006	Increase (+)	Decrease (–)
Current Assets :	**Rs.**	**Rs.**	**Rs.**	
Debtors	30,000	70,000	40,000	
Stock	60,000	65,000	5,000	
Cash	30,000	45,000	15,000	
	1,20,000	1,80,000		
Current Liabilities :				
Sundry Creditors	86,000	95,000		9,000
	86,000	95,000		
Working capital	34,000	85,000		
Increase in Working Capital	**51,000**			**51,000**
	85,000	85,000	60,000	60,000

FUNDS FLOW STATEMENT

Sources of Funds	Rs.	Applications of Funds	Rs.
Share Capital (including premium)	35,000	Purchase of Furniture	2,000
Sale of Plant	800	Dividend paid	25,000
Funds from Operations	82,200	Investments Purchased	20,000
		Tax paid	20,000
		Increase in Working Capital	51,000
	1,18,000		1,18,000

The increase in Working capital in Schedule of Changes in Working Capital is confirmed with the increase in working capital in Funds Flow Statement.

Note: Shares for Rs. 20,000 were issued at par for redemption of debentures. This transaction does not find a place in Funds Flow Statement and Schedule of Changes in Working Capital as both the items are non-current.

Working:

ADJUSTED PROFIT & LOSS ACCOUNT

To Dividend paid	Rs. 25,000	By Balance b/d	Rs. 10,000
To Provision for taxation	30,000	By Funds from operations	
To Transfer to General Reserve	10,000	(Balancing figure)	82,200
To Plant (Depreciation)	8,000		
To Furniture (Depreciation)	1,000		
To Loss on Sale of Plant	1,200		
To Balance c/d	17,000		
	92,200		92,200

Dr. PLANT ACCOUNT Cr.

To Balance b/d	Rs. 1,04,000	By Bank	Rs. 800
		By P & L (loss on sale of plant)	1,200
		By Provision for Depreciation (on plant sold)	2,000
		By Balance c/d	1,00,000
	1,04,000		1,04,000

Dr. FURNITURE ACCOUNT Cr.

To Balance b/d	Rs. 7,000	By Balance c/d	Rs. 9,000
To Cash (balancing figure)	2,000		
	9,000		9,000

Dr. PROVISION FOR DEPRECIATION ON FURNITURE Cr.

To Balance b/d	Rs. 6,000	By Balance c/d	Rs. 5,000
		By P & L A/c (depreciation charged for the year balancing figure)	1,000
	6,000		6,000

Dr. PROVISION FOR DEPRECIATION ON PLANT Cr.

To Plant Account (Depreciation on plant sold)	Rs. 2,000	By Balance c/d	Rs. 50,000
To Balance c/d	56,000	By P & L A/c (depreciation charged for the year balancing figure)	8,000
	58,000		58,000

10.11 FUNDS FLOW STATEMENT, INCOME STATEMENT AND BALANCE SHEET

Funds flow statement is not a substitute of an income statement i.e. a profit and loss account and a balance sheet. Their purposes are different. Funds flow statement is not competitive but complementary to these financial statements.

Differences Between Funds Flow Statement and Income Statement

Base	Funds Flow Statement	Income Statement
1. Purpose	Shows the means the funds were obtained and ways these funds were used.	Find out profit or loss of the organisation.
2. Scope	Includes both capital and revenue items.	Only revenue items are considered.
3. Knowledge	Provides information on working capital and changes in financial position.	Depicts the items of expenses and income to arrive at profit or loss in business.
4. Format	No Prescribed format	Prescribed format exists for companies like insurance companies, banking companies and electricity companies.
5. Compulsory	A Voluntary statement in case of sole proprietor and partnership firms.	Compulsory to prepare even in the case of proprietor and partnership firms for submission before tax authorities. Compulsory in case of limited companies under Companies Act.
6. Period	Prepared for short intervals.	Prepared yearly and sometimes half-yearly.
7. Preparation	Complementary to Income Statement. Income statement helps the preparation of Funds Flow Statement.	Income Statement is not prepared from Funds Flow Statement.

Differences Between Funds Flow Statement and Balance Sheet

Base	Funds Flow Statement	Balance Sheet
1. Nature	It is a statement of changes in financial position and hence dynamic in nature.	It is a statement of financial position on a particular date and hence static in nature.
2. Aim	Prepared to verify whether working capital is managed effectively or not.	To ascertain and verify the value of assets and liabilities on a particular date.
3. Publication	Not required to be published.	In the case of limited companies, Balance Sheet is published and required to be circulated among the shareholders.
4. Compulsory	A Voluntary statement in case of proprietorship and partnership firms.	Compulsory in case of limited companies under Companies Act.
5. Period	Prepared occasionally.	Prepared at the end of the accounting period.
6. Preparation	Usually, Schedule of Changes in Working Capital is prepared before preparing Funds Flow Statement.	No Schedule of Changes in Working Capital is prepared. Rather Profit and Loss Account is prepared before the preparation of Balance Sheet

10.12 LIMITATIONS OF FUNDS FLOW STATEMENT

Funds Flow Statement is an important tool for analysis and serves several useful purposes. However, its limitations cannot be ignored and they are:

1. It is not an original statement. It is only a rearrangement of data taken from the financial statements (Profit and Loss Account and Balance Sheet).
2. It is based on the financial statements and so the limitations of financial statement are equally applicable to them.
3. It is essentially historic in nature and projected statement cannot be prepared with much accuracy.
4. Funds Flow Statement is not a substitute for basic financial statements like profit and loss account and balance sheet. At best, it can be a supplementary statement to explain the changes in working capital.

Despite the above limitations, Funds Flow Statement serves the basic purpose of explaining the causes for changes in the financial position of the firm between two periods.

Descriptive Questions:

1. Explain the need, meaning, importance and objectives of Funds Flow Statement? **(10.1 and 10.4)**
2. Describe the significance of Funds Flow Statement to the different users? **(10.5)**
3. Describe the need and limitations of Funds Flow Statement? **(10.1 and 10.12)**
4. What are the different Sources and Applications in a Funds Flow Statement? **(10.2, 10.6 and 10.8)**
5. "Depreciation can be taken as a source of funds in a limited sense". Illustrate with a suitable example? **(10.7)**
6. "Depreciation is an indirect source of funds under certain circumstances – Explain? **(10.7)**
7. Depreciation is a source to the extent of reduction of tax liability – Explain with a suitable example? **(10.7)**
8. Explain briefly the procedure and steps to be followed for preparing Funds Flow Statement? **(10.1 and 10.10)**
9. Differentiate between :
   (a) Funds Flow Statement and Income Statement **(10.11)**
   (b) Funds Flow Statement and Balance Sheet **(10.11)**

Check Your Understanding

(A) State whether the following statements are True or False

1. The term 'fund' in a fund flow statement refers to working capital.
2. Loss on sale of machine should be added to net profit for calculating funds from operations.
3. Statement of change in financial position can be either funds flow statement or cash flow statement.
4. Income statements need not be prepared but funds flow statements are required to be compulsorily prepared.
5. Basic financial statements (Profit and Loss account and Balance sheet) fail to show the movement and causes of changes in assets and liabilities during the year.
6. Statement of change in financial position identifies changes in assets, liabilities and the shareholders' funds over a given period.
7. Funds flow statement points out the sources from which additional funds have been received during the year and the uses to which funds have been applied.
8. In funds flow statement, if both the affected accounts relate to working capital only they appear.
9. As per existing legal requirement, in case of a limited company, it is not required to publish statement of changes in financial position along with other financial statements.
10. Flow of funds takes place from transactions, when one account is current and the other is non-current.

11. A funds flow statement shows diversion of working capital for purchase of fixed assets.

Answers

1. True 2. True 3.True 4. False 5. True 6. True 7. True 8. False 9. False 10. True. 11. True

(B) Pickup the correct answer

1. Stock at the end results in the
   (a) Application of fund. (b) Source of funds.
   (c) No flow of funds.
2. Sale of investments indicate
   (a) Source of funds. (b) Application of funds.
   (c) None of the above.
3. Tax paid is
   (a) Application of funds. (b) Source of funds.
   (c) No flow of funds.
4. Which of the following will result in flow of funds :
   (a) Purchase of furniture on credit. (b) Writing of goodwill.
   (c) Depreciation of assets. (d) Appreciation in Building.
5. Net profit earned plus non- operating expenses is equal to
   (a) Funds provided by operations. (b) Use of funds.
   (c) Sinking fund.
6. Depreciation is a source of funds
   (a) Yes (b) No
   (c) Both Yes and NO
7. An increase in the share premium account is
   (a) An application of funds. (b) A source of funds.
   (c) No flow of funds.
8. Increase in a fixed asset due to issue of shares is
   (a) Source of funds. (b) Use of funds
   (c) None.
9. By preparing provision for taxation A/c, we can find out the missing figure of …
   (a) Taxes paid during the year. (b) Taxes provided during the year.
   (c) Either of a. & b. above. (d) Neither of a. & b. above.
10. A company engaged in financial activities receives interest. Such interest is …
    (a) Operating income. (b) Non-operating income.
    (c) Loss from operation. (d) Non-operational charge.

11. … is not a current asset.
    (a) Book debts.
    (b) Short-term investment.
    (c) Long-term investment.
    (d) Stock.
12. … is not a current liability.
    (a) Sundry Creditors.
    (b) Bank overdraft.
    (c) Outstanding expenses.
    (d) Long-term loan
13. X Ltd has sales revenue of Rs.2,000. Depreciation for the period is Rs. 3,000. Other operating expenses are Rs. 900. Net loss for the period is Rs.500.

    What is the amount of funds generated from operations during the period by X Ltd?
    (a) 2,500
    (b) 1,500
    (c) 3,500
    (d) 1,400

Answer (B)

1 (b), 2 (a), 3 (a), 4 (a), 5 (a), 6 (c), 7 (b), 8 (c), 9 (c), 10 (a), 11 (c), 12 (d), 13 (a)

(C) Pick up the most appropriate answer:

1. If depreciation on furniture is in the additional information, it will be posted…
    a. At the debit side of adjusted profit and loss A/c.
    b. At the credit side of plant A/c.
    c. Neither of a & b. above.
    d. At both a. & b. above
2. Current liabilities are equal to …
    a. Working capital + Current assets.
    b. Work-capital – Current assets.
    c. Current assets – Working capital.
    d. Current assets + Working capital.
3. Inflow of funds does not take place due to …
    a. Funds from operation.
    b. Increase in capital.
    c. Increase in working capital.
    d. Sale of fixed assets.
4. Increase in working capital is…
    a. Source of funds.
    b. Application of funds.
    c. Funds from operation.
    d. Loss from operation.
5. Vehicle sold for credit for a vehicle dealer results in…
    a. Increases working capital
    b. Decreases working capital
    c. Does not change working capital
6. Cash realisation from debtors increases working capital
    a. Yes
    b. No
    c. None of the above answers

Answers (C)

1. (d) . 2. (c). 3. (c). 4. (b) 5. (c) 6. (b)

(D) Fill in blanks:

1. Any gain on sale of non-current assets should be … from the net profit for determining funds from operations.
2. Difference between Current Assets and Current Liabilities is known as …
3. Funds flow refers to changes in …
4. Depreciation is sometimes treated as … funds.
5. Goods purchased on credit … in flow of funds.
6. Increase in working capital is … of funds.
7. Vehicle sold on credit is … of funds.
8. Furniture sold for cash … funds flow.

Answers (D)

1. Deducted. 2. Working Capital. 3. Working capital. 4. A source. 5. Does not result. 6. An application. 7. A source. 8. Increases

Interview Questions

Q.1. When we have financial statements of Profit and Loss Account and Balance Sheet, what is the need of Funds Flow Statement, separately?

Ans. Financial statements like Profit and Loss Account and Balance Sheet are static statements. Profit and Loss Account shows the financial results in a consolidated manner during a specific period, combining results of operating performance as well as non-operating performance. Firm may be in loss and the true picture may be concealed with the profits of non-operating activities.

Balance Sheet shows the statement of assets and liabilities on a fixed date. It shows the financial position at the end of a specified period, but does not explain the causes for the changes during the period.

Funds Flow Statements show the operating results from operations, non-operations, separately. How the funds have been raised and equally the ways they are deployed is explained in the funds flow statement.

Funds Flow Statement shows the sources and uses of funds. It also explains the causes and diversion of funds from short-term sources to long-term uses and vice versa. Reason for failure and success of business can be better understood with this statement. Funds Flow Statement gives a comprehensive picture, which the normal financial statements do not provide. So, there is a separate need for the funds flow statement.

Q.2. What is the purpose of 'Schedule of changes in working capital'?

Ans. In the context of 'Source and Application of Funds Statement', the term 'Funds' mean 'working capital'. This statement 'Schedule of changes in working capital' shows the increase or decrease of working capital during a specified period. Further, this statement provides information for the causes or reasons for increase / decrease of working capital. From which sources, this working capital is raised or to what purposes there has been diversion of working capital are known from this statement.

In other words, the story behind the change in the financial position between the beginning and end of a period is known.

Q.3. Who are the users of the Funds Flow Statement and for what purpose this statement is used?

Ans. Funds Flow Statement is widely used by the financial institutions, banks and credit rating agencies. By preparing the statement, the user can know well, in advance, about the adequacy or otherwise of working capital position for proper planning.

Q.4. What is a Non-operating profit and give an example?

Ans. Non-operating profit is that amount of profit, which is not connected with the regular business. Examples are loss on sale of assets, dividend income on trade investments and rent from building, not connected to the business.

Q.5. What is depreciation? What is its impact on cash?

Ans. Depreciation is decrease in the value of an asset due to wear and tear, passage of time, obsolescence, exhaustion and accident**.** It is a part of capital cost of fixed asset, spread over the life of the asset. Depreciation is taken as an operating expense, while arriving at true profits of a business. Depreciation is, simply, a book entry to arrive at book profits. Depreciation is a non-cash item. Depreciation does not result in any outgo of cash.

Q.6. Is Depreciation a direct source of funds?

Ans. No. Depreciation is not a direct source of funds. Depreciation is an indirect source of funds to a limited extent. It depends upon circumstances. If the firm is in profits, depreciation acts as a tax shield in helping the firm for reducing tax liability. Income tax act permits depreciation as an admissible expenditure to the extent it is provided, as per its rules. As a result, taxable profits and tax liability are reduced. So, to that extent, depreciation is a source. In consequence, depreciation is a source to the extent tax liability is reduced. Due to depreciation, profits available for distribution of dividend get reduced. So, more funds would be available to the business for expansion. In these circumstances, depreciation is a source. But, when the firm is in loss, question of tax payment does not rise. In those circumstances, depreciation is not a source. It can be said, with certainty, that depreciation is not a source of funds, directly. **So,** d**epreciation is only an indirect source to a limited extent, under certain circumstances.**

Q.7. Explain the different meanings of the term “Funds”?

Ans. The term “Funds” has different meanings. Its popular meaning is ‘working capital’. Based on this meaning, Funds Flow Statement is prepared. The second meaning – narrow meaning - is ‘cash’. Based on this meaning, Cash Flow Statement is prepared. The third meaning, broad in nature, is ‘Total Resources’. Based on this meaning, Statement of Total Financial Resources is prepared.

Q.8. What is meant by ‘Operating Profit’? From which statement, you can find out this item? Explain the importance of the relevant statement in the context of operating profit?

Ans. Operating profit refers to profit from business operations. This is the business profit, after deducting all the expenses incurred for earning that profit. Operating profit does not include other incomes, not connected with main business, and equally the expenses connected to earn such other incomes.

Operating profit can be found from the Statement of Sources and Application of Funds as this item is shown separately. At times, the firm may be in net profit, even though the business may be sustaining business losses, due to higher other incomes. Other incomes may be neutralizing the business loss. Normal Profit and Loss Account shows only the final profit or loss in a combined manner. It does not show that the business operations are in loss. As the real picture is not known, corrective action may be delayed or not known at all, till the business collapses. Only Statement of Sources and Application of Funds throws the real picture about profit or loss from business operations and other operations, separately. Statement of Sources and Application of Funds exposes what profit and loss account may conceal.

Q.9. In what manner can 'Statement of Sources and Application of Funds' be utilized by financial institutions?

Ans. Normally, commercial banks sanction working capital limits. Before sanction, commercial bank wants to assess the needs and requirements of the working capital limits of the borrowers. After sanction, bank wants to ensure that there is no diversion of working capital limit for other purposes. Borrowers may use the working capital limits for purchase of fixed assets and withdraw funds for the personal use, against the terms of sanction. Banks can utilize the statement to find out any diversion of working capital limit. Funds Flow Statement is used to achieve the above objectives.

Term lending institutions want to satisfy, before sanction, that the projects, proposed to be financed, would generate sufficient funds to service the debt. These institutions want to ensure that the borrower would have sufficient funds to pay the installment and interest amounts, during the proposed repayment period.

Sources and Application of Funds, the other name for the above statement, is highly used by the financial institutions to monitor end use of funds and repayment of the loans sanctioned.

Q.10. What are Long-term sources?

Ans. Long-term sources are share capital, reserves, long term loans and debentures etc.

Q11. What are Short-term sources and when they are due for payment?

Ans. Short-term sources are creditors for goods and services, short-term working capital facilities, provided by banks and outstanding expenses etc. Even employees, technically, provide short duration credit as salaries are paid, after the end of the month. Basically, these short-term funds are to be repaid in the normal course of business, as per payment terms, normally, within a period of one year.

Q.12. What is the golden rule in respect of long-term and short-term sources of funds? What is the consequence of diversion of funds?

Ans. The golden rule is long-term funds are to be used for long term purposes and short term purposes. These funds can be used for purchase of fixed assets and a part for meeting working capital requirements. Long term sources are permanent or remain in the business firm, relatively, for a very long period. So, there is no pressure on these funds for repayment in a short period.

Short term sources are to be used only for short term uses, but not for long term applications. Short term sources, at times, are used for long term purposes, such as purchase of fixed assets or luxurious vehicles, basically for those purposes, which are not to be used. When a firm uses short term sources for long term uses, there would be crunch of funds and experiences difficulty in meeting short term obligations. This situation leads to liquidity crunch and may even lead to insolvency in serious situations.

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