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BBA | Semester 6 | UK6DSCMGT302

Accounting for Managers

Course Code: UK6DSCMGT302 • Module 4 Notes

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Module 4: Funds Flow Statement

Concept of Funds, Working Capital Changes, FFO Determination, and Comprehensive Preparation

Chapter 1: Theoretical Concept of Funds and the Dynamics of Fund Flows

1.1 Definitional Scope and Meaning of 'Funds'

In commercial financial management and accounting theory, the term **Funds** carries multiple interpretations depending upon analytical context. In a narrow sense, funds denotes unencumbered cash and bank balances. In a broader sense, funds signifies total financial resources available to an enterprise. However, in the technical discipline of financial statement analysis, funds is universally defined on a **Working Capital Basis**—specifically representing **Net Working Capital** (the surplus of Total Current Assets over Total Current Liabilities):

$$\text{Net Working Capital (Funds)} = \text{Total Current Assets } (CA) - \text{Total Current Liabilities } (CL)$$

Theoretical Rationale: A pure cash perspective is overly restrictive because it ignores short-term claims and obligations that are continuously maturing into cash. The net working capital concept captures the entire circulating capital reservoir that fuels daily industrial operations.

1.2 The Golden Rule of Flow of Funds

The term **Flow of Funds** signifies a net change or movement in working capital—either an expansion (**Source of Funds**) or a contraction (**Application of Funds**). Commercial transactions do not automatically cause a flow of funds. The fundamental governing rule of fund flow states:

> **The Fundamental Flow Invariant:** A flow of funds occurs *if and only if* a commercial transaction affects simultaneously **one Current Account** and **one Non-Current (Permanent) Account**.

To systematically evaluate any corporate transaction, accounts are categorized into four structural quadrants:

1. **Current Assets (CA)** (Cash, Bank, Debtors, Bills Receivable, Inventories, Marketable Securities).
2. **Current Liabilities (CL)** (Creditors, Bills Payable, Outstanding Expenses, Short-Term Bank Overdrafts).
3. **Non-Current (Fixed) Assets (NCA)** (Land and Buildings, Plant and Machinery, Patents, Long-Term Investments).
4. **Non-Current (Permanent) Liabilities and Equity (NCL)** (Share Capital, Debentures, Long-Term Bank Loans, Capital Reserves, Retained Earnings).

Transaction Category	Accounts Involved	Impact on Net Working Capital	Flow Classification
Current Asset vs Current Liability	CA and CL	No Change in Net Working Capital	**No Flow of Funds**
Non-Current Asset vs Non-Current Liability	NCA and NCL	No Change in Net Working Capital	**No Flow of Funds**
Current Asset vs Non-Current Asset	CA and NCA	Increases or Decreases Net Working Capital	**Flow of Funds Occurs**
Current Asset vs Non-Current Liability	CA and NCL	Increases or Decreases Net Working Capital	**Flow of Funds Occurs**
Current Liability vs Non-Current Asset	CL and NCA	Increases or Decreases Net Working Capital	**Flow of Funds Occurs**
Current Liability vs Non-Current Liability	CL and NCL	Increases or Decreases Net Working Capital	**Flow of Funds Occurs**

1.3 Concrete Transactional Demonstrations of Flow vs. Non-Flow

The operational mechanics of this golden rule can be verified through explicit corporate accounting examples:

- *Example A (No Flow - CA and CL):* Payment of Rs. 50,000 to trade creditors in cash. Current Assets decrease by Rs. 50,000 and Current Liabilities decrease by Rs. 50,000. Net Working Capital ($CA - CL$) remains entirely unchanged. **Result: No Flow of Funds.**
- *Example B (No Flow - NCA and NCL):* Issuance of equity shares of Rs. 5,00,000 directly to vendors for the purchase of plant machinery. A non-current asset increases and a non-current equity account increases. Working capital is unaffected. **Result: No Flow of Funds.**
- *Example C (Flow - CA and NCL):* Fresh issuance of 10% debentures for Rs. 10,00,000 cash. Cash (Current Asset) increases by Rs. 10,00,000 while Debentures (Non-Current Liability) increase. Net working capital increases by Rs. 10,00,000. **Result: Source of Funds.**
- *Example D (Flow - CA and NCA):* Purchase of factory land for Rs. 8,00,000 cash. Cash (Current Asset) decreases by Rs. 8,00,000 while Land (Non-Current Asset) increases. Net working capital contracts by Rs. 8,00,000. **Result: Application of Funds.**

1.4 Objectives, Significance, and Inherent Limitations of the Funds Flow Statement

A **Funds Flow Statement** is a financial report that reveals the underlying movement of long-term financial resources into and out of an enterprise during an accounting period. It explains why working capital expanded or contracted despite reported accounting profits or losses.

The primary managerial objectives and benefits include: (1) explaining the structural reallocation of financial resources between two balance sheet dates; (2) demonstrating how capital expenditure

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programs were financed (e.g., whether fixed assets were financed prudently through long-term equity or dangerously through short-term supplier debt); (3) guiding corporate dividend policy by showing available unencumbered funds; and (4) aiding commercial banks in evaluating long-term creditworthiness.

The inherent limitations include: (a) it is a historical document that records past events rather than prospective trajectories; (b) it fails to reveal intra-period seasonal liquidity swings; (c) it combines non-cash items with cash items inside working capital, masking immediate liquidity crises; and (d) it omits significant non-fund transactions (such as asset acquisitions via share allotments) unless supplemented by detailed schedules.

Chapter 2: The Schedule of Changes in Working Capital

2.1 Structural Design and Governing Mathematical Principles

The initial operational step in preparing a Funds Flow Statement is compiling the **Schedule of Changes in Working Capital**. This schedule lists every individual Current Asset and Current Liability for the opening and closing dates of the accounting period, calculating the net increase or net decrease in working capital.

The governing mathematical relationships are structured as follows:

1. **Current Assets Dynamics:** An increase in a Current Asset results in an **Increase in Working Capital** ($\Delta CA > 0 \implies +\Delta WC\$$). A decrease in a Current Asset results in a **Decrease in Working Capital** ($\Delta CA < 0 \implies -\Delta WC\$$).
2. **Current Liabilities Dynamics:** An increase in a Current Liability results in a **Decrease in Working Capital** ($\Delta CL > 0 \implies -\Delta WC\$$). A decrease in a Current Liability results in an **Increase in Working Capital** ($\Delta CL < 0 \implies +\Delta WC\$$).

> $$\text{Net Change in Working Capital} = (\sum CA_{\text{closing}} - \sum CL_{\text{closing}}) - (\sum CA_{\text{opening}} - \sum CL_{\text{opening}})$$
>
> **Balancing Invariant:** The net increase or decrease computed in the Schedule of Changes in Working Capital must exactly match the balancing figure of the final Funds Flow Statement.

2.2 Standard Format of the Schedule of Changes in Working Capital

Working Capital Item	Opening Balance (Rs.)	Closing Balance (Rs.)	Effect on Working Capital: Increase (+)	Effect on Working Capital: Decrease (-)
Current Assets:				
Cash in Hand & at Bank	A1	A2	If A2 > A1	If A2 < A1

Working Capital Item	Opening Balance (Rs.)	Closing Balance (Rs.)	Effect on Working Capital: Increase (+)	Effect on Working Capital: Decrease (-)
Marketable Investments	B1	B2	If B2 > B1	If B2 < B1
Trade Receivables (Debtors)	C1	C2	If C2 > C1	If C2 < C1
Inventories (Raw, WIP, Finished)	D1	D2	If D2 > D1	If D2 < D1
Prepaid Operating Expenses	E1	E2	If E2 > E1	If E2 < E1
Total Current Assets (A)	**Total CA1**	**Total CA2**		
Current Liabilities:				
Trade Payables (Creditors)	F1	F2	If F2 < F1	If F2 > F1
Bills Payable	G1	G2	If G2 < G1	If G2 > G1
Outstanding Operating Expenses	H1	H2	If H2 < H1	If H2 > H1
Short-Term Bank Overdraft	I1	I2	If I2 < I1	If I2 > I1
Total Current Liabilities (B)	**Total CL1**	**Total CL2**		
Net Working Capital (A - B)	**NWC1**	**NWC2**		
Net Increase / Decrease in WC	Balancing Figure	Balancing Figure	**Sum (+)**	**Sum (-)**

Chapter 3: Calculation of Funds from Operations (FFO)

3.1 Conceptual Foundations of Funds from Operations

The reported net profit appearing in the commercial Statement of Profit and Loss cannot be equated with the net funds generated by regular business operations. Accounting net profit is calculated after

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debiting numerous non-cash expenses (such as depreciation of plant and machinery, amortization of goodwill, write-off of preliminary expenses) and non-operating losses (loss on disposal of capital assets), as well as crediting non-operating revenues (profit on disposal of land, dividend income from long-term investments). **Funds from Operations (FFO)** reconstructs the authentic volume of operational funds generated exclusively by core commercial revenue-earning activities.

3.2 Methods of Calculating FFO

Funds from Operations can be derived using two interchangeable presentation formats:

Format 1: The Add-Back Statement Method

> Net Profit for the Year (Closing Surplus less Opening Surplus)
>
> **Add** :Non-Cash and Non-Operating Items Debited to P&L:
>
> - Depreciation on Fixed Assets
> - Amortization of Intangible Assets (Goodwill, Patents, Trademarks)
> - Preliminary Expenses or Discount on Shares/Debentures Written Off
> - Loss on Sale of Fixed Assets or Long-Term Investments
> - Transfer to General Reserve, Sinking Fund, or Contingency Reserve
> - Proposed Dividend or Interim Dividend Paid during the period
> - Provision for Corporate Income Taxation (if treated as non-current)
>
> **Less** :Non-Operating and Capital Incomes Credited to P&L:
>
> - Profit on Sale of Fixed Assets or Investments
> - Dividend or Interest Income Received from Non-Trade Investments
> - Revaluation Reserves or Excess Provisions Written Back
>
> **Equals** :Funds from Operations (FFO)

Format 2: The Adjusted Profit and Loss Account (T-Account Format)

In the T-account ledger presentation, the opening credit balance of Profit and Loss (Surplus) is credited. Non-cash expenses, reserves, and dividend appropriations are debited. Non-operating gains and the closing balance of Profit and Loss are credited. The balancing figure on the credit side represents **Funds from Operations (FFO)** (if balancing figure falls on the debit side, it represents **Funds Lost in Operations**).

Chapter 4: Architecture of the Funds Flow Statement

4.1 Comprehensive Classification of Sources and Applications

The final Funds Flow Statement synthesizes all long-term financial flows into a balanced two-sided structural report:

Sources of Funds (Inflows of Long-Term Capital)	Applications of Funds (Outflows of Long-Term Capital)
Funds from Operations (FFO) (if positive)	**Funds Lost in Operations** (if negative)
Fresh Allotment of Equity Share Capital for Cash	Redemption of Redeemable Preference Shares
Fresh Allotment of Preference Share Capital for Cash	Redemption / Buyback of Debentures
Issue of Debentures / Long-Term Debt Instruments	Repayment of Long-Term Bank Borrowings / Mortgages
Raising of Long-Term Loans from Financial Institutions	Purchase of Fixed Assets (Land, Plant, Machinery, Buildings)
Sale Proceeds from Disposal of Fixed Assets	Purchase of Long-Term Non-Current Investments
Sale Proceeds from Disposal of Long-Term Investments	Payment of Equity / Preference Dividends
Non-Operating Cash Inflows (Dividends / Interest Received)	Payment of Corporate Income Tax (when non-current)
Net Decrease in Working Capital (Balancing inflow)	**Net Increase in Working Capital** (Balancing outflow)

4.2 Critical Structural Invariants

> $$\sum \text{Sources of Funds} - \sum \text{Applications of Funds} = \text{Net Increase in Working Capital}$$
>
> $$\text{Alternatively: } \sum \text{Sources of Funds} = \sum \text{Applications of Funds}$$
>
> **Accounting Harmony:** When the Net Increase in Working Capital is treated as an Application of Funds (or Net Decrease treated as a Source), the two grand totals of the Funds Flow Statement must be mathematically identical.

Chapter 5: Advanced Accounting Adjustments in Funds Flow

5.1 Treatment of Provision for Taxation

In corporate financial accounting, Provision for Taxation can be modeled under two distinct accounting paradigms:

1. **Treated as a Current Liability:** If tax provision is classified as a short-term current liability, opening and closing balances are included directly in the Schedule of Changes in Working Capital. Under this treatment, actual tax payments during the year require no separate entry in the Funds Flow Statement, and no adjustment is made to FFO.
2. **Treated as an Appropriation of Profit (Non-Current Liability):** This represents the preferred academic and standard professional approach. The provision is excluded from the Schedule of Working Capital. A separate *Provision for Taxation Account* is maintained:

> $$\text{Tax Paid (Cash Outflow)} = \text{Opening Provision} + \text{Provision Made in Current P\&L} - \text{Closing Provision}$$
>
> **Dual Posting:** Current year tax provision is added back to Net Profit in calculating FFO; actual cash tax paid is reported as an **Application of Funds**.

5.2 Treatment of Proposed and Interim Dividends

Dividends declared or paid by enterprise directors are managed under standard accounting conventions:

- **Proposed Dividend:** Treated as an appropriation of profit. A separate ledger account is prepared. The dividend proposed in the previous financial year is assumed to be paid during the current year (recorded as an **Application of Funds**). The dividend proposed for the current year is added back to Net Profit in computing FFO.
- **Interim Dividend:** An interim dividend declared and paid within the identical financial period is simultaneously added back to Net Profit in calculating FFO and recorded as an **Application of Funds**.

5.3 Provision for Depreciation and Fixed Asset Disposal Accounting

When an enterprise records fixed assets at gross historical cost with a separate accumulated depreciation account, the disposal of machinery requires careful multi-ledger reconciliation:

> $$\text{Book Value of Disposed Asset} = \text{Gross Cost} - \text{Accumulated Depreciation on Disposed Asset}$$
>
> $$\text{Gain or Loss on Disposal} = \text{Cash Sale Proceeds} - \text{Book Value}$$
>
> **Flow Postings:** The full cash sale proceeds represent a **Source of Funds**. The loss on sale is added back in FFO (or gain subtracted). Depreciation charged for the year on surviving assets is added back in FFO. Any balancing debit figure in the Fixed Asset Account represents **Purchase of Fixed Assets (Application of Funds)**.

Chapter 6: Comprehensive Worked Numerical Problems in Funds Flow

6.1 Worked Problem 1: Full-Scale End-to-End Funds Flow Compilation

The comparative Balance Sheets of Sterling Synthetics Ltd. as of 31st March for two consecutive financial years are presented below:

Equities and Liabilities	Previous Year (Rs.)	Current Year (Rs.)	Assets	Previous Year (Rs.)	Current Year (Rs.)
Equity Share Capital (Rs. 10)	6,00,000	8,00,000	Plant & Machinery (Gross)	8,00,000	11,00,000
General Reserve	2,00,000	2,80,000	Less: Accumulated Depreciation	(1,80,000)	(2,40,000)
Profit & Loss Account (Surplus)	1,20,000	1,90,000	Net Plant & Machinery	6,20,000	8,60,000
11% Debentures	3,00,000	2,00,000	Freehold Land & Buildings	4,00,000	3,50,000
Trade Payables (Creditors)	1,80,000	2,10,000	Long-Term Investments	1,00,000	1,60,000
Outstanding Wages	40,000	20,000	Inventories (Stock)	2,40,000	2,90,000
Provision for Taxation	80,000	1,00,000	Trade Receivables (Debtors)	1,50,000	2,00,000
Proposed Dividend	60,000	80,000	Cash & Bank Balances	70,000	20,000
Total	**15,80,000**	**18,80,000**	**Total**	**15,80,000**	**18,80,000**

Additional Transactional Information for Current Year:

1. A machine costing Rs. 1,00,000 with accumulated depreciation of Rs. 40,000 was sold during the year for Rs. 50,000 cash.
2. Freehold land costing Rs. 50,000 was sold at a net gain of Rs. 20,000, and the profit was credited directly to the Profit and Loss Account.
3. Corporate income tax paid during the current year amounted to Rs. 75,000.
4. Dividend proposed in the previous year (Rs. 60,000) was paid in full during the year.
5. Treat Provision for Taxation and Proposed Dividend as non-current liabilities (appropriations).

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Required: Prepare (a) Schedule of Changes in Working Capital; (b) Relevant Ledger Accounts; (c) Statement of Funds from Operations; and (d) Funds Flow Statement.

Step-by-Step Mathematical Resolution:

Step 1: Schedule of Changes in Working Capital:

Particulars	Previous Year (Rs.)	Current Year (Rs.)	Increase in WC (Rs.)	Decrease in WC (Rs.)
Current Assets:				
Inventories	2,40,000	2,90,000	50,000	-
Trade Receivables	1,50,000	2,00,000	50,000	-
Cash & Bank Balances	70,000	20,000	-	50,000
Total Current Assets (A)	**4,60,000**	**5,10,000**		
Current Liabilities:				
Trade Payables	1,80,000	2,10,000	-	30,000
Outstanding Wages	40,000	20,000	20,000	-
Total Current Liabilities (B)	**2,20,000**	**2,30,000**		
Net Working Capital (A - B)	**2,40,000**	**2,80,000**		
Net Increase in Working Capital	**40,000**	-	-	**40,000**
Total Reconciled	**2,80,000**	**2,80,000**	**1,20,000**	**1,20,000**

Step 2: Reconstruction of Non-Current Ledger Accounts:

1. Plant & Machinery Account (At Gross Cost):

> Debit: Opening Balance $= \text{Rs. } 8,00,000$
>
> Credit: Machinery Disposed (Gross Cost) $= \text{Rs. } 1,00,000$
>
> Credit: Closing Balance $= \text{Rs. } 11,00,000$
>
> Debit Balancing Figure: Purchase of Plant $= 11,00,000 + 1,00,000 - 8,00,000 = \text{Rs. } 4,00,000$

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Action: Purchase of Plant Rs. 4,00,000 is an **Application of Funds**.

2. Accumulated Depreciation Account:

$$\text{Credit: Opening Balance} = \text{Rs. } 1,80,000$$

$$\text{Debit: Depreciation on Disposed Machine} = \text{Rs. } 40,000$$

$$\text{Debit: Closing Balance} = \text{Rs. } 2,40,000$$

$$\text{Credit Balancing Figure: Depreciation Provided for Year} = 2,40,000 + 40,000 - 1,80,000 = \text{Rs. } 1,00,000$$

Action: Depreciation charged Rs. 1,00,000 is **added back to FFO**.

3. Profit / Loss on Sale of Machinery:

$$\text{Book Value} = 1,00,000 - 40,00,000 = \text{Rs. } 60,000$$

$$\text{Sale Proceeds} = \text{Rs. } 50,000 \implies \text{Loss on Sale} = 60,000 - 50,000 = \text{Rs. } 10,000$$

Action: Cash Sale Proceeds of Rs. 50,000 is a **Source of Funds**; Loss on Sale of Rs. 10,000 is **added back to FFO**.

4. Freehold Land & Buildings Account:

$$\text{Debit: Opening Balance} = \text{Rs. } 4,00,000$$

$$\text{Credit: Closing Balance} = \text{Rs. } 3,50,000 \implies \text{Cost of Land Sold} = \text{Rs. } 50,000$$

$$\text{Sale Value of Land} = 50,000\ (\text{Cost}) + 20,000\ (\text{Gain}) = \text{Rs. } 70,000$$

Action: Cash Sale Proceeds of Rs. 70,000 is a **Source of Funds**; Profit of Rs. 20,000 is **deducted from FFO**.

5. Provision for Taxation Account:

$$\text{Credit: Opening Balance} = \text{Rs. } 80,000$$

$$\text{Debit: Tax Paid Cash} = \text{Rs. } 75,000$$

$$\text{Debit: Closing Balance} = \text{Rs. } 1,00,000$$

$$\text{Credit Balancing Figure: Tax Provision Created in P\&L} = 1,00,000 + 75,000 - 80,000 = \text{Rs. } 95,000$$

Action: Tax Provision of Rs. 95,000 is **added back to FFO**; Tax Paid of Rs. 75,000 is an **Application of Funds**.

Step 3: Statement of Funds from Operations (FFO):

Particulars	Amount (Rs.)
Closing Balance of Profit & Loss Account (Surplus)	1,90,000
Less: Opening Balance of Profit & Loss Account	(1,20,000)
Net Profit Earned during the Year	**70,000**
Add: Non-Cash and Non-Operating Items:	
Transfer to General Reserve (2,80,000 - 2,00,000)	80,000
Depreciation Provided for Year	1,00,000
Loss on Sale of Plant Machinery	10,000
Current Year Tax Provision	95,000
Proposed Dividend for Current Year	80,000
Subtotal Additions	**3,65,000**
Less: Non-Operating Income:	
Profit on Sale of Freehold Land	(20,000)
Funds from Operations (FFO)	**4,15,000**

Step 4: Final Funds Flow Statement for Year Ended 31st March:

Sources of Funds	Amount (Rs.)	Applications of Funds	Amount (Rs.)
Funds from Operations (FFO)	4,15,000	Purchase of Plant & Machinery	4,00,000
Fresh Issue of Equity Shares	2,00,000	Purchase of Long-Term Investments	60,000
Sale Proceeds of Plant Machinery	50,000	Redemption of 11% Debentures	1,00,000
Sale Proceeds of Freehold Land	70,000	Payment of Income Tax	75,000
		Payment of Previous Year Proposed Dividend	60,000

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Sources of Funds	Amount (Rs.)	Applications of Funds	Amount (Rs.)
		Net Increase in Working Capital	**40,000**
Grand Total Sources	**7,35,000**	**Grand Total Applications**	**7,35,000**

Verification: The net increase in working capital of Rs. 40,000 derived in the Funds Flow Statement exactly matches the Rs. 40,000 increase computed in the Schedule of Changes in Working Capital, confirming 100% accounting harmony.

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