CHAPTER IV

WORKING CAPITAL CHANGES
THE FUNDS FLOW STATEMENT

INTRODUCTION

4.1.1 The operations of business enterprise comprise conversion of funds to assets and reconversion to funds. The funds used in this circuit flow may come from different sources. The selection of these sources and their application bear strongly upon the financial soundness of the business.

4.1.2 Financial management refers to management of funds, their flow from one investment to other. The record of past has an impact on the present and future flow of funds.

4.1.3 Funds flow analysis shows the manner in which the funds are raised and invested and the changes in them over time. If working capital is drawn down to procure fixed assets, for example, this fact should quickly become apparent.

4.1.4 The funds flow statement renders a full and clear account of what has happened to funds. It reveals the influence of profit or loss upon financial structure, and also high lights firm's profitability and liquidity.

4.1.5 This chapter discusses the concept of funds flow and the different methods of preparation, interpretation, and refinements of the funds flow statement.

FINANCIAL STATEMENTS

4.2.1 These refer to and include balance sheet and profit and loss account prepared by firms at the end of accounting period. Recently, funds flow statement has become popular as another financial statement.

BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

4.2.2 These statements are conventional, statutory and widely understood. They report on two dimensions of financial accounting namely values and profits. Measurement of profits and values are interdependent. Two balance sheets at the beginning and at the end of a period is linked by the profit and loss account. Balance sheet and profit and loss account have one point of reconciliation i.e., the capital account.

4.2.3 The two financial statements differ from each other. The profit and loss account tells about continuing health of a firm. It is a summary of causes of profit or loss. On the other hand balance sheet is a statement of the firm's financial position. It enlists things owned and things owed to others by firm at a point in time.

4.2.4 Profit and loss account relates to transactions of one year affecting the retained earning. Beyond that it is silent. It does not show the financial position at any particular time. " It fails to reveal the well being (or ill being) of a company at a single moment to show the things the company owns and the things it owes." [1] Further, the effects of non-operating transactions on retained earning are also not revealed.

1. Lindsay. J.Robert, et al., Op. cit., p.9

4.2.5 Balance sheet states the financial condition of a firm. It is one statement of firms properties and owings at one moment. For the purpose, " the dynamics of actual financial existence are momentarily suspended, and the amount of assets, liabilities and owner's investment at that instant is reported." [1]

4.2.6 Thus the balance sheet describes the stock of values that a company has at a particular time. The profit and loss account deals with flow of values during a period of time or, with income-expense flow only. The stocks of values of balance sheet are not comparable with flow of values in profit and loss account. " For our purposes, the best way to bring the balance sheet and income statement together is to state them both as flows." [2] That becomes the funds flow statement.

VALUE OF FUNDS FLOW INFORMATION

4.3.1 Business operations result in a series of transactions which become either source or use of funds. These operations are preplanned and affect funds. Unanticipated changes in funds arise due to following reasons :

1. failure to keep up to plan,
2. unnoticed financial deterioration, and
3. variation in firm's financial position.

One common effect of the situations is excessive depletion of working capital. The reason could be in most cases misapplication

1. Wessel, R.Robert, Principles of Financial Analysis. A Study of Financial Management, New York : The Macmillan Company, pp. 30-70

2. Smith, Robert L., Management Through Accounting, Englewood Cliffs, N.J., Prentice-Hall Inc., 1962, pp. 160-170

or wrong use of working capital, or accumulation of debts for carrying out capacity expansion. Management would like to know the exact couse of changes from a funds flow analysis.

4.3.2 The outside analyst is required to adise on investment worthiness of a company to a prospective investor. He will be interested in the financial position and also in the capability of management. The flow of funds helps the analyst as well as the management to " appraise the impact and quality of management decisions made in business during a given period of time." [1]

4.3.3 The funds flow statement charts the new uses to which funds have been applied and the sources from which they come from. A series of statements will show the manner and magnitude of changes. Thus the analysis lies in examining " the manner in which distribution of the company's resources changes with the passage of time," [2] over different phases in the life of firm.

TYPES OF FUNDS FLOW ANALYSIS

4.4.1 Meaning and Concept of Funds Funds can be defined in three ways. The broadest meaning of funds is economic values, the narrowest meaning is cash. In between it refers to working capital. Each one of these definitionSis discussed below.

4.4.2 Funds as " economic values " comprise the total of all resources available with a firm expressed in monetary terms. They are " described in the list of assets to which the funds have been committed. The source of these values is described in the list of equities ... ." [3] It is too broad.

1. Helfert, Erich A., Techniques of Financial Analysis, Homewood, Illinois : Richard D. Irwin, Inc, 1967, pp. 6,7
2. Wessel, Robert H., Op. cit., pp. 55-56
3. Smith, Robert L., Op.cit., p. 169

4.4.3 Funds as cash reduces the statement of funds flow to an account of receipts and disbursement of cash. It is narrow, so fails to bring into light many important changes in the distribution of resources. Large part of business relates to credit transactions.

4.4.4 Funds defined as " Working Capital " refers to the long funds used in current assets. It is more inclusive than cash. It reflects the financial condition of a firm. The sales require certain assets and expansion in sales increases the requirement of investment. The changes in these assets reflect the nature of sources and application of funds in business.

CONCEPT OF FLOW

4.5.1 The flow refers to the change in forms of assets and liabilities. The chief source of funds is sales. Besides the borrowers and the owners also provide a part of funds requirement. The flow is initiated by cash the original form of funds. One part is spent in fixed assets. That does not have a cash flow in a short one-year-period. The other part is spent for merchandise and expenses of producing goods. The goods when sold produce cash or remain as debtors before becoming cash. The cash thus generated are used to repay the trade creditors, bank creditors or otherswhich were utilized to procure inventory or to pay expenses. The remaining balance can be put into operations again, technically called restarting of the cycle, if entirely not distributed to owners as dividend.

4.5.2 Occassionally additional funds from owners and/or creditors are brought in which may be put into current assets to increase sales or may be invested in fixed assets which helps in the process of enlarging the cycle. Thus funds flow is dynamic and regenerative.

SCOPE OF ANALYSIS

4.6.1 Analysis can be wide or narrow to analyse funds changes in cash, economic values, working capital, or part there of relating to one or a group of accounts. Thus the scope is quite elastic with concept of funds chosen. The technique is based on tracing the individual transactions behind a netchange in balance sheet items. The changes in current assets minus current liabilities could be excmined for working capital analysis. The different analyses are described below.

STATEMENT OF CASH FLOW

4.7.1 This statement shows the direct impact of transactions on cash. It can be prepared by recasting items of profit and loss account on cash basis, or by adding cash receipts minus cash disbursements to the opening cash balance of a period. The cash flow is equal to funds provided by operations : that is " sum of net income, depreciation, depletion, and amortization, (and) intangible development expenses."[1] The statement can not be prepared by outside analyst due to lack of access to details.

1. IBA Report, " The Security Underwriters Analyse To-day's Investment Scene ", Barron's December,5.1960, p. 5 Cf. Parry Mason, p. 4

STATEMENT OF BALANCE SHEET CHANGES

4.7.2 The preparation has two steps : First noting the change in individual accounts, second, classifying them as funds source or use. Changes in balance sheet items like increase in assets and decrease in liabilities are uses of funds the reverse are sources.

4.7.3 The statement includes also changes in non-fund items, and covers up result of several changes in one net change. These inaccuracies are negligible over shorter period of comparison. A skilled user makes mental allowance for these , so statement is quite suitable for a rough and ready analysis with low cost.

STATEMENT OF WORKING CAPITAL CHANGES

4.7.4 Current assets are used for business operations. At the end of operation the value increases or decreases according to profit earned or loss incurred. Statement is prepared to show working capital changes. Each increase in current assets and decrease in current liabilities increases working capital and the reverse changes decreases working capital. Current assets minus current liabilities may be expressed in one figure or it may be separately shown as increase/decrease in individual current accounts. The net change reflects impact of long funds. So it does not disclose funds changes in non-fund and non-current areas. This statement could be interpreted as follows.

INTERPRETATION OF WORKING CAPITAL CHANGES

4.7.5 Working capital has two constituents and one net change may reflect several degrees of changes in each. These variations in change are used for interpretation of financial position.

(a) Increase in working capital The increase may be produced under three different circumstances :

(i) current assets increase more than current liabilities

(ii) current assets decline less than current liabilities

(iii) current assets increase while current liabilities decline.

Situation one generally indicates growth. The relative increase in each shows different degrees of current financial position. Situation two shows stability if the reduction in current assets is appropriate from operational angle. Situation three is both a growth and progressively stable current position. These conclusions are highly generalised. The reasons of changes must be ascertained for a correct interpretation. The sources of funds used to affect changes may come from long-term creditors, owners, or from sale of fixed assets. The former is growth oriented whereas the latter is symptom of financial strain or incapacity.

(b) Decrease in working capital The decrease is produced by the following situations.

(i) current liabilities rising faster than current assets

(ii) current liabilities falling at slower rate than current assets

(iii) current liabilities rising simultaneously with current assets

Generally situation one arises under unsound expansion. The situations two and three indicate different degrees of financial weakness or deterioration.

4.7.6 The increase/decrease in whrking capital reflects respectively larger financing from long fund or smaller financing from long-funds available for current assets. Thus the statement of working capital helps to interpret working capital changes interms of fixed investment.

STATEMENT OF SOURCES AND USES

4.7.7 This statement is accepted both as a statement of financial position and as an interpretative tool. It brings to light the underlying funds flows behind account changes for a period. It reveals the following events :

1. What has been done to cash or resources allied to cash raised from operations or/ and additional sources,

2. pin points the corresponding investments or uses of funds so collected.

4.7.8 The statement classifies the funds as sources and uses in the following manners

Sources

1. increase in equity or retained profit

2. increase in long-term liabilities

3. disposal by sale of fixed assets

Uses

1. reduction in capital : redemption of capital, paymeht of dividend, financing loss

2. reduction in long-term liabilities

3. acquisition of fixed assets or equipments

The statement is prepared from details of ledger accounts directly or indirectly from balance sheet changes. The first type of statement can be prepared by management only. The outside analyst's statement must be confined to information available in financial statements : like profit and loss account and balance sheet. He has to make certain adjustments in balance sheet changes for eliminating non-fund items and amplifying fund implications according to accounting convention.

STEPS TO PREPARATION

4.7.9 The steps to preparation are given below.

(a) Recording the changes in balance sheet accounts and classifying those as fund source or use

(b) Increase in assets/decrease in liabilities are stated as uses and reversely as sources

(c) Adjustments in items to amplify the full implication of funds.

The steps (a) and (b) are similar to balance sheet changes discussed already. The adjustments made in them are discussed below.

THE ADJUSTMENTS

4.7.10 There are three types of adjustments : one, to show pertinent information ; two, to restore writeoffs to income ; three, to eliminate non-fund effects.

4.7.10 (1) Disclosing pertinent information The most common information here pertains to (a) change in retained earning and (b) change in fixed assets. The net increase in retained earning or surplus account is the effect of increase in profit first and dividend paid second. The net decrease in this account may be due to writing off surplus and raising capital account by an equal amount. The analysis of these net changes could be amplified thus increase in profit, and capital as sources, and payment of dividend and reduction of surplus as uses.

4.7.12 One net change in fixed assets account in effect is the product of (a) addition and disposition of fixed assets ; (b) depreciation charged ; and (c) writing off the accounts for retirement. With details of disposal and acquisitions the flow of fund is calculated easily but outside analyst may not get them. So adjustment is carried out by a theoretical presumption. One year's depreciation charge is equal to increase in accumulated depreciation account of that year. They differ if latter account is written off for retirement of assets. Thus change is fixed assets is equal to the net change in fixed assets account at the beginning and at the year end plus depreciation charged to profit and loss account.

4.7.13 (2) Restoring deductions to Net Profit Accounting practice requires that all expenses should be deducted from net sales revenue to arrive at net profit. Some of the expenses donot use funds or they are non-fund expenses, or book adjustments only. They are in the nature allocation of heavy past expenses which affected funds then. Some such items are depreciation, amortization, taxation, development and other reserves offset from operating income. So funds generated from operation is arrived by reversing these expenses by adding back to net profit.

4.7.14 (3) Elimination of non-fund balance sheet changes Some changes are non-fund and donot affect working capital. A few common examples are retirement of fully depreciated assets, and issue of stock dividend. Such items are adjusted by simply reversing the entries to the original formeer they are ignored.

PRESENTATION OF THE FUNDS STATEMENT

4.8.1 The form may show the changes in total resources of firm or some selected resources. The form which is selected is dependent upon the purpose of analysis. It should help in assessment of financial position. The usual forms of the statement are discussed below.

CLASSIFICATION OF THE FORMS

4.9.1 Broadly all types of presentation can be grouped in three classes as follows.

First, gives the different source and the various uses. Then it states the excess of sources over uses as increase and the excess of uses over sources as decrease in working capital.

Second, begins with the opening balance of cash then shows the sources and uses. The statement ends in the closing cash balance. The difference of opening and closing cash balance is either an increase or a decrease in cash.

Third, presents the sources and uses of funds in two groups with equal totals. The change in long-term funds forms a single figure; and the changes in current assets/liabilities during the period under review are shown as specific sources and uses.

For the purpose of an analyst the funds statement should suit his investigation. The precision of statement depends upon his access to details of ledger accounts. So the analyst with limited access to details prepares this from balance sheet and profit and loss account information. Two most popular formats of funds flow statement used for working capital analysis are given in page 107 A.

4.9.2 Format I states the long-term sources and uses and operating income or loss. Such statement arranged for a series of years will help to identify the usual and unusual flows of funds. Each funds source has certain financial significance such as increased operating income highlights the capacity of income generation internally or use of funds for meeting losses. Further the sources of funds inflows have certain relation with uses. Additional funds may be put to instal capacity or to augment working assets or both. Such facts are quite clear from this statement.

4.9.3 Format II shows the changes in individual working capital components. The change increases in particular current asset component has its implication on current position. Increase in inventory or debtors may be due to needs for operation or on account of inefficiency. These changes, their pattern and proportion to total funds flow will require further analysis. For debtors may accumulate and the use of funds may continuously increase if liberal credit is given. Inventory may consume funds if stock remain unsold. The movement in one is related to other. Such as inventory may be reduced by sales but if they are not realised they will show up as debtors. Lastly all these funds uses may come from long funds i.e., increase of net working capital. They may be a funds source if there is net decrease or working capital deficit. Similarly the current liabilities items will show

FORMAT I

Statement of Sources and Applications of Funds

Sources	Rs.	Applications	Rs.
(1) Issue of share capital		(1) Redemption of Redeemable Preference share capital	
(2) and Debentures		(2) and Debentures	
(3) Institutional Loan obtained		(3) Repayment of Institutional loans	
(4) Sale of investments and other fixed assets		(4) Purchase of investments and other fixed assets	
(5) Trading Profits or Funds from operation		(5) Payment of dividend	
(6) Non-trading income		(6) Non-trading expenses	
Sub-Total		Sub-Total	
(7) Decrease in Working Capital		(7) Increase in Working Capital	
Total		Total	

FORMAT II

Statement of Changes in Working Capital

Items	Previous Year	Current Year	Effect on Working Capital Increase	Decrease
Current Assets :				
Inventory				
Debtors				
OthersCurrent Assets				
Sub-Total(a) Rs.				
Current Liabilities:				
Bank Credits				
Trade Credits				
Other Current Liabilities				
Sub-Total(b) Rs.				
Working Capital (a-b) Rs.				
Increase/Decrease				

the sources of short-term funds use and the pattern over the years. This can be interpreted in relation to long-term funds availability.

SUMMARY AND CONCLUSION

4.10.1 There are several methods of financial statement analysis. The funds flow technique is most appropriate for working capital analysis. Working capital management has two objectives : that of profitable operations and repayment capacity through higher liquidity. The balance sheet shows the financial condition of firm at a point of time, the profit and loss account depicts the experience of firm over the course of time. Funds statement brings balance sheet and profit and loss account together by stating them as flows . These statements compared over a period of time pin-point the sources and uses of funds.

4.10.2 Funds means cash or economic values or, working capital. The funds stated as working capital is helpful since it is more inclusive than cash and narrower than economic value. Because assets may be purchased and paid for in cash, or the amount due may be owed to supplier : either will affect working capital. The funds flow in a circular manner. It begins with an outflow of cash for purchase of materials, expenses for production which result in finished goods. When these are sold some return as cash and others becomes higher through profit earned or becomes lower than the original if losses are incurred. Some other inflows from longfunds increase the funds which helps to increase level of operations.

4.10.3 The flow can be picturised in full details. But considerations of purpose at hand, convenience, and economy of preparation make method of balance sheet changes relatively advantageous. With the help of financial statement information some refinement in details on net income changes, and net property changes is possible. Such a statement helps external analyst to detect undesirable flows like funds used for financing loss and long-term use of short-term funds. The format for reporting is flexible and depends upon the details desired. The report which states long funds and funds from operation as sources and uses ending up in increase or decrease in working capital helps to pin-point impact of long funds flows on working capital. An explanation to this is found in analysing the details of changes in working capital components in another statement.