# Collegedunia NCERT Notes

*The Ultimate Revision Guide for Class 12 Accountancy (Chapter 6 of Part 2)*

NCERT 2026-27 / New Syllabus

## NCERT Class 12 Accountancy Notes Part 2 Chapter 6: Cash Flow Statement

**Also see for this chapter: NCERT Solutions | Formula Sheet**

## Contents

# 1 Introduction and Objectives

By Class 12 you have already drafted two of the three core financial statements: the Position Statement (Balance Sheet, which shows what the firm owns and owes on a given date) and the Income Statement (Statement of Profit and Loss, which shows the operating result over a period). Both are prepared on the **accrual basis**, they recognise revenue when earned and expenses when incurred, regardless of when cash actually moves. That is excellent for measuring economic performance, but it leaves a serious gap for the user of accounts: *where did the cash come from, and where did it go?*

A firm can post a healthy net profit and still default on its salary bill, because profit and cash are not the same thing. The **Cash Flow Statement** (CFS) closes this gap by classifying every rupee of cash movement during the year under three heads, operating, investing, and financing, and reconciling the opening cash balance with the closing one.

## 1.1 Meaning under AS-3

The statement is governed by **Accounting Standard 3 (Revised), Cash Flow Statement**, notified under Section 133 of the Companies Act, 2013. Under the Companies Act, 2013 Section 2(40), the term “financial statements” itself **includes** the Cash Flow Statement, so for almost all companies (small companies, OPCs and dormant companies are exempted) preparing a CFS is mandatory, not optional.

AS-3 defines a cash flow statement as a statement showing the **historical changes in cash and cash equivalents** of an enterprise, with cash flows classified into operating, investing and financing activities for a given accounting period.

**Three-Activity Classification**

Every cash inflow and outflow in the year must be parked under exactly one of three buckets:

- **Operating**, the principal revenue-generating activities (the day-to-day business).
- **Investing**, acquisition and disposal of long-term assets and non-current investments.
- **Financing**, changes in the size and composition of owners' capital and borrowings.

The sum of the three net flows, added to opening cash, must equal closing cash, a built-in arithmetic check.

## 1.2 Objectives of the Statement

The primary objective is to provide users of financial statements with useful information about cash inflows and outflows during the period under each of the three activity heads. Specifically, the statement helps users to:

1. Assess the enterprise's ability to **generate** cash and cash equivalents.
2. Assess the enterprise's **need** to deploy those cash flows, whether for replacement of assets, repayment of loans, or dividend distribution.
3. Evaluate the **timing and certainty** of cash generation, which is the central input to almost any economic decision.

## 1.3 Benefits of Cash Flow Statement

- **Net-asset assessment**, used alongside Balance Sheet and P&L, the CFS lets users evaluate changes in net assets, financial structure (liquidity, solvency) and the firm's ability to flex cash flows with changing circumstances.
- **Comparability across firms**, because it strips out accounting-policy differences (depreciation method, inventory valuation), the same cash event looks the same in every firm's CFS, making inter-firm comparison reliable.
- **Future cash-flow modelling**, users develop discounted-cash-flow valuations using historical CFS as the anchor.
- **Checks past forecasts**, compares the cash actually generated with what management had projected, exposing forecasting drift.
- **Links profitability with liquidity**, explains why a profitable firm can still be cash-poor (e.g. revenue locked in receivables) or why a loss-making firm can sit on cash (e.g. heavy non-cash depreciation).

**Real-World Application**

In 2008–09 several profitable Indian real-estate companies defaulted on short-

term debt: their P&Ls were green, but their cash flow statements showed massive outflows trapped in work-in-progress inventory and receivables. Reading only the P&L would have missed the liquidity crunch entirely, the cash flow statement screamed it on the first page.

# 2 Cash, Cash Equivalents and Cash Flows

Before classifying activities, the chapter pins down what exactly is being tracked.

## 2.1 Definition of Cash and Cash Equivalents

**Cash**, per AS-3, comprises **cash in hand** and **demand deposits with banks** (current accounts and ordinary saving accounts).

**Cash equivalents** are short-term, highly liquid investments that are:

- Readily convertible into known amounts of cash, and
- Subject to an **insignificant risk** of change in value.

By convention an investment qualifies as a cash equivalent only when its maturity is **three months or less** from the date of acquisition. Treasury bills, commercial paper of three-month tenor and short-term marketable securities meet this bar.

**Quick Tip**

Investments in equity shares are **never** cash equivalents (they carry market-price risk). The only exception AS-3 carves out is *preference shares acquired shortly before their specific redemption date*, where redemption value is fixed and credit risk is insignificant.

**Why three months?**

Three months is short enough that interest-rate movements barely shift market value, so the investment behaves like cash but earns a small return while parked. Treasurers use cash equivalents to "sweep" idle balances without locking up funds.

## 2.2 Meaning of Cash Flow

A **cash flow** is the movement of cash and cash equivalents into or out of the enterprise on account of some non-cash item. Receipts are **cash inflows**; payments are **cash outflows**.

- Sale of machinery for cash, inflow.
- Purchase of machinery for cash, outflow.

- Collection from a trade receivable, inflow.
- Payment to a trade payable, outflow.

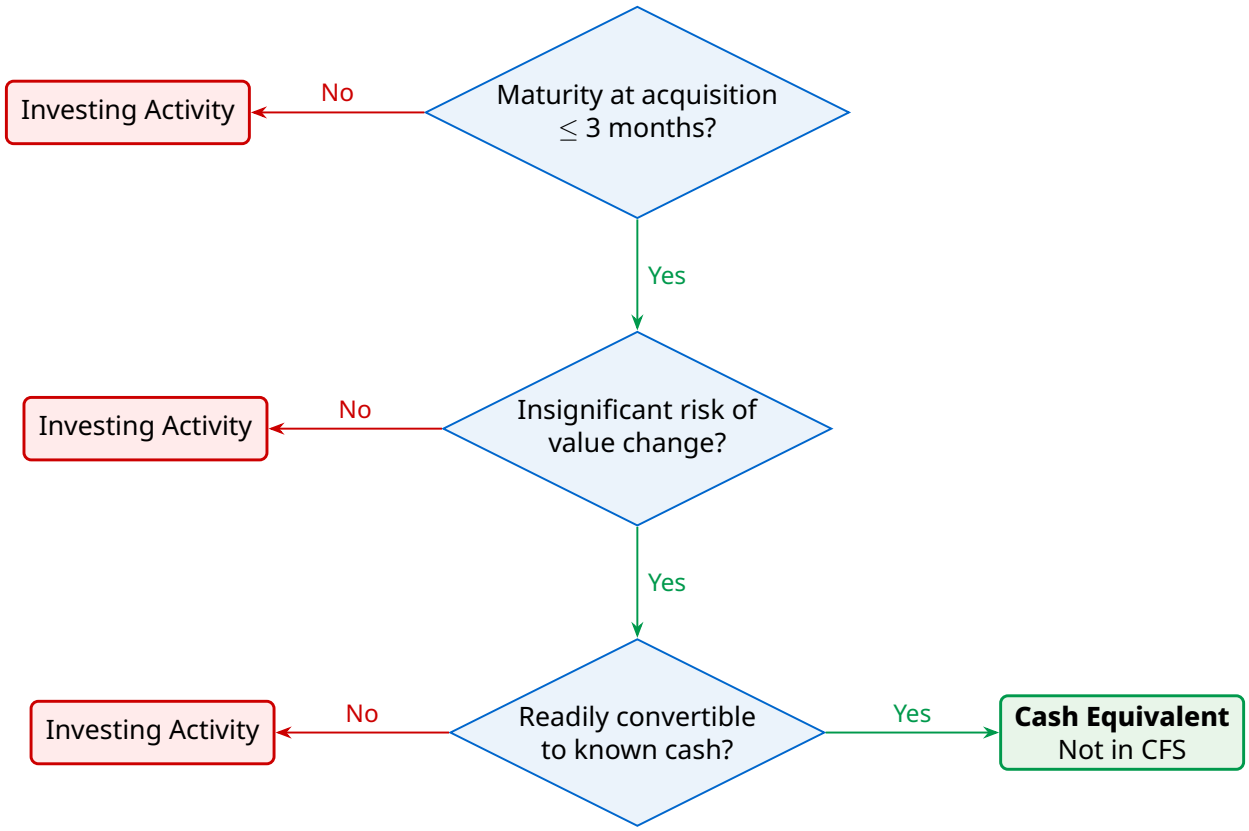
Movements *between* cash and cash equivalents (e.g. depositing cash to buy a 90-day T-bill, or redeeming a 90-day T-bill back to bank balance) are **not cash flows**. They are part of cash management and net out within the "cash and cash equivalents" pool.

**Common Mistake**

Students often list "purchase of marketable securities (90-day)" as an investing outflow. It is not, the security *is* a cash equivalent, so the transaction is an internal shuffle and never appears in the CFS.

## 2.3 Decision Tree, Is It a Cash Equivalent?

A short visual is the quickest way to decide whether a particular short-term investment is a cash equivalent or an investing item. Walk the three questions in order.




*All three answers must be Yes for an item to qualify as a cash equivalent under AS-3.*

# 3 Classification of Activities

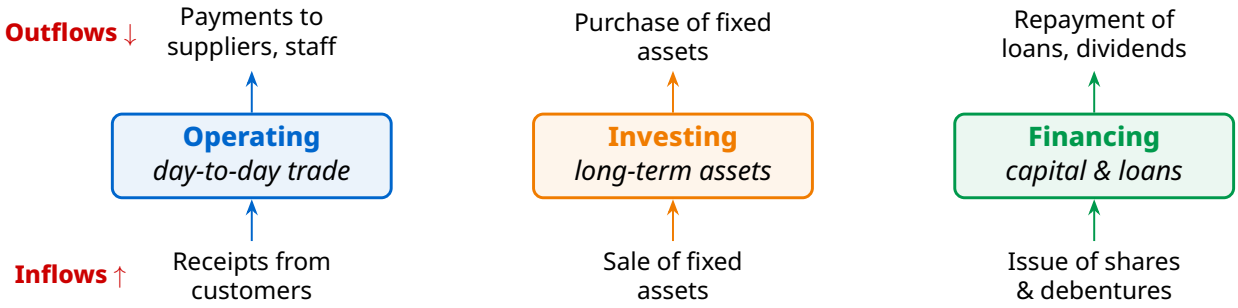
This is the heart of the chapter and a perennial 1-mark / 3-mark question. Memorise the buckets cold.

## 3.1 Operating Activities

Operating activities are the **principal revenue-generating** activities of the enterprise, and any other activity that is neither investing nor financing. Cash flows from operations indicate whether the firm's own trade is producing enough cash to sustain operations, replace assets, pay dividends and repay loans **without external funding**. This is the headline number every analyst looks at first.

**Operating cash inflows and outflows, typical list**

**Inflows:** cash receipts from sale of goods and services; royalties, fees, commission and other revenue.
**Outflows:** cash paid to suppliers; cash paid to and on behalf of employees; insurance premiums and claims; income-tax on operating profit.
For financial enterprises (banks, NBFCs), purchase and sale of dealing/trading securities and loans made to customers are also operating, because that *is* their main business.




*The three buckets, with the most common inflows and outflows under each.*

## 3.2 Investing Activities

Investing activities are the **acquisition and disposal** of long-term assets and other investments *that are not* cash equivalents. Separate disclosure of these flows is important because they signal the extent to which the firm is investing for the future.

**Investing outflows:** cash paid to acquire fixed assets (tangible and intangible, including capitalised R&D); cash paid to acquire shares, warrants or debt of other enterprises (other than those held for trading); cash advances or loans to third parties (other than by a financial enterprise).

**Investing inflows:** cash receipts from disposal of fixed assets, from sale of long-term investments, from repayment of loans made to third parties, plus **interest**

**received** on debentures and other interest-bearing investments and **dividend received** on shares held as investments (for a non-financial enterprise).

**Investing Activities, Cheat-Sheet**

| Inflows | Outflows |
|---|---|
| Sale of fixed asset | Purchase of fixed asset |
| Sale of long-term investment | Purchase of long-term investment |
| Loan repayments received | Loans given to third parties |
| Interest received | Capital gains tax on disposal |
| Dividend received | |

*The investing block is anchored on long-term assets and non-current investments; interest/dividend received sit here for a non-financial firm.*

## 3.3 Financing Activities

Financing activities are those that result in changes in the **size or composition** of owners' capital (including preference share capital) and borrowings of the enterprise.

**Financing inflows:** proceeds from issue of equity or preference shares; proceeds from issue of debentures, bonds, loans or other long-term and short-term borrowings.

**Financing outflows:** repayment of borrowings; interest paid on debentures and long-term loans; **dividend paid** on equity and preference capital; buy-back of equity shares; redemption of preference shares or debentures.

**Financing Activities, Cheat-Sheet**

| Inflows | Outflows |
|---|---|
| Issue of equity shares | Repayment of borrowings |
| Issue of preference shares | Redemption of debentures |
| Issue of debentures or bonds | Buy-back of equity |
| Long-term loan raised | Interest paid on borrowings |
| Short-term loans raised | Dividend paid (equity & pref.) |

*The financing block tracks every change in the size or composition of owners' capital and borrowings.*

## 3.4 Master Comparison Table

| Activity | Typical Inflow | Typical Outflow |
|---|---|---|
| Operating | Receipts from customers; commission, royalty | Payments to suppliers, employees; income-tax on operating profit |
| Investing | Sale of plant; sale of long-term investment; interest & dividend received | Purchase of plant; purchase of long-term investment; loans given |
| Financing | Issue of shares; issue of debentures; long-term loan raised | Repayment of loan; redemption of debentures; interest & dividend paid |

## 3.5 Treatment of Some Peculiar Items

A handful of items reappear in nearly every exam question. Memorise their classification.

**Extraordinary items**, non-recurring events such as loss by theft, earthquake or insurance claims received. Cash flows from extraordinary items must be classified and *disclosed separately* as arising from operating, investing or financing activities, so that users can isolate the recurring base.

**Interest and dividend**, the treatment depends on the type of enterprise:

- For a **financial enterprise** (bank, NBFC), interest paid, interest received and dividend received are all **operating**; only dividend paid is financing.
- For a **non-financial enterprise** (the default in NCERT problems): interest paid and dividend paid are **financing** outflows; interest received and dividend received are **investing** inflows.

> **Memory Aid**
>
> **"Pay-Fin, Get-Invest"** for non-financial firms: whatever interest/dividend you **pay** is Financing; whatever you **get** is Investing.

**Taxes on income**, AS-3 requires income-tax cash flows to be disclosed separately and classified as **operating** unless they can be specifically identified with financing or investing. Hence:

- Tax on operating profit, operating outflow.
- Dividend distribution tax, financing outflow (alongside dividend paid).
- Capital gains tax on sale of fixed assets, investing outflow.

**Non-cash transactions**, pure book entries with no cash movement must be ex-

cluded from the CFS. Common examples: acquisition of machinery by issuing equity shares, conversion of debentures into equity, bonus issue. These are disclosed in the notes to accounts so the user is not blind to them, but the CFS itself remains a cash-only statement.

**Common Mistake**

"Conversion of debentures into shares" is NOT a financing inflow followed by a financing outflow. It is one non-cash transaction, **ignore it entirely** in the cash flow statement and add a note instead.

# 4 Method of Preparation, Direct vs Indirect

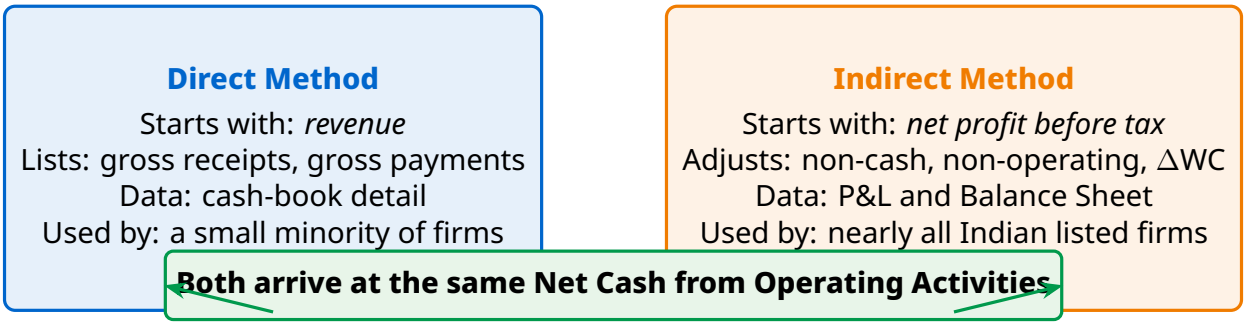
For investing and financing activities, only one method exists: list each receipt and payment under its head. For operating activities, AS-3 permits two methods.

## 4.1 The Two Methods at a Glance

**Direct method**, discloses major classes of gross cash receipts and gross cash payments. Start with revenue, deduct cash paid for purchases, salaries, operating expenses and tax, and you arrive at net cash from operating activities directly. Conceptually clearest but data-hungry, you need each cash line, which most accounting systems do not produce as a default.

**Indirect method**, starts from net profit before tax and extraordinary items and adjusts for: (i) non-cash items (depreciation, goodwill written off); (ii) non-operating items (interest paid, profit/loss on sale of fixed asset); (iii) changes in working capital (current assets and current liabilities). Less intuitive but far easier to extract from the existing P&L and Balance Sheet, which is why almost every Indian company in practice uses it.

**The NCERT syllabus focus is the indirect method.** Every illustration after Section 6.6 uses it, and the board paper will too.




*Two paths, one destination: the bottom-line operating cash figure is identical.*

### 4.2 Why the Two Methods Give the Same Answer

The P&L is the cash result with three layers of accrual "noise" added: non-cash entries (depreciation), non-operating entries (interest, profit/loss on disposals), and working-capital changes (receivables, payables, inventory). Strip all three layers off and you are back to the cash receipts minus cash payments that the direct method shows directly.

**Indirect-method intuition in one line**

Cash from ops $=$ Net profit before tax $+$ (non-cash charges) $+$ (non-op losses) $-$ (non-op gains) $\pm$ (working-capital changes) $-$ Tax paid

## 5 Indirect Method, Step-by-Step

This section is the workhorse of the chapter. Almost every numerical you will see (board and competitive exams alike) is a direct application of the proforma below.

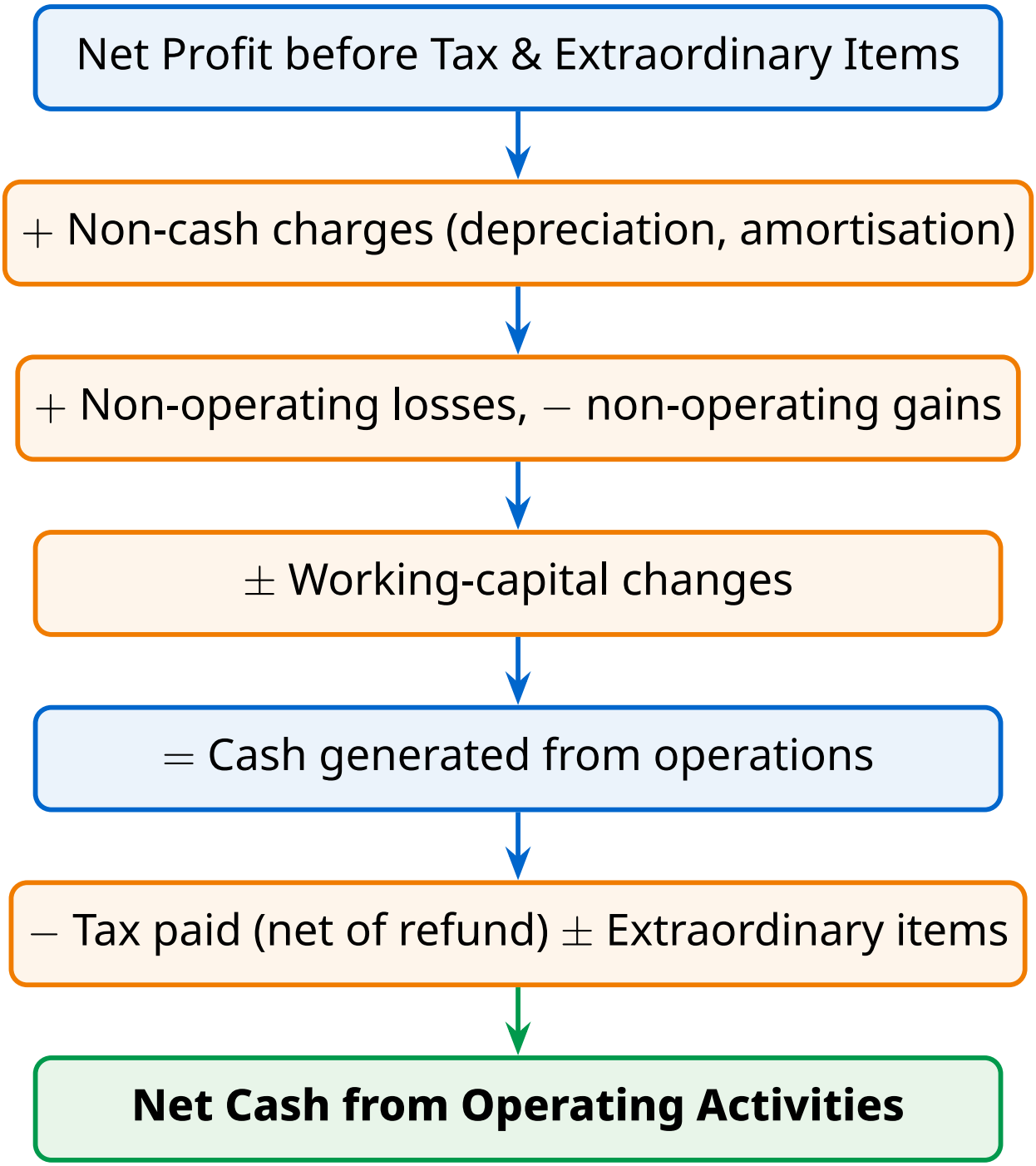
### 5.1 The Standard Proforma

**Cash Flow from Operating Activities (Indirect Method)**

| | |
|---|---|
| Net Profit before Tax and Extraordinary Items | xxx |
| *Add: Non-cash and non-operating items debited to P&L* | |
| + Depreciation, amortisation, goodwill written off | xxx |
| + Interest on borrowings (finance cost) | xxx |
| + Loss on sale of fixed assets / investments | xxx |
| + Provision for doubtful debts / tax (no cash effect) | xxx |
| *Less: Non-operating items credited to P&L* | |
| − Interest received | (xxx) |
| − Dividend received | (xxx) |
| − Profit on sale of fixed assets / investments | (xxx) |
| **Operating Profit before Working Capital Changes** | xxx |
| *Adjust for working-capital changes* | |
| + Decrease in current asset (other than cash) | xxx |
| + Increase in current liability | xxx |
| − Increase in current asset (other than cash) | (xxx) |
| − Decrease in current liability | (xxx) |
| **Cash Generated from Operations** | xxx |
| − Income-tax paid (net of refund) | (xxx) |
| ± Effect of extraordinary items | xxx |
| **Net Cash from Operating Activities** | **xxx** |

## 5.2 Indirect Method, Workflow at a Glance

The proforma above can be read as a single top-down flow. Each rung adjusts net profit to remove one type of accrual noise, until only the cash effect of operations is left.




*Read top to bottom. Each rung removes one source of accrual noise.*

## 5.3 Step 1: Start with Net Profit before Tax and Extraordinary Items

You will rarely be given this figure directly. The two situations:

- **Statement of P&L is supplied**, read off "Profit before tax". If only "Profit after tax" is shown, add back the provision for tax.
- **Only Balance Sheets are supplied**, compute it as:

$$\text{Net Profit before Tax} = \Delta\text{Surplus in Reserves} + \text{Proposed Dividend (CY)} + \text{Provision for Tax (CY)} + \text{Transfer to Reserves, etc.}$$

  Each item that was *deducted* from current-year profit before posting to the Balance Sheet has to be added back.

## 5.4 Step 2: Add back Non-cash and Non-operating Charges

Anything that was debited to P&L but did not cause a cash outflow during the year:

- **Depreciation, amortisation, goodwill / patents / preliminary expenses written off**.
- **Provision for doubtful debts** (created during the year, it is a book entry until the debtor is actually written off).
- **Loss on sale of fixed asset / investment**, the actual cash inflow appears under investing; the loss is just the book-entry mismatch.
- **Finance cost (interest on debentures / loans)**, the actual cash outflow appears under financing; we add it back here to neutralise it.

## 5.5 Step 3: Subtract Non-operating Credits

Items credited to P&L that did not arise from operations:

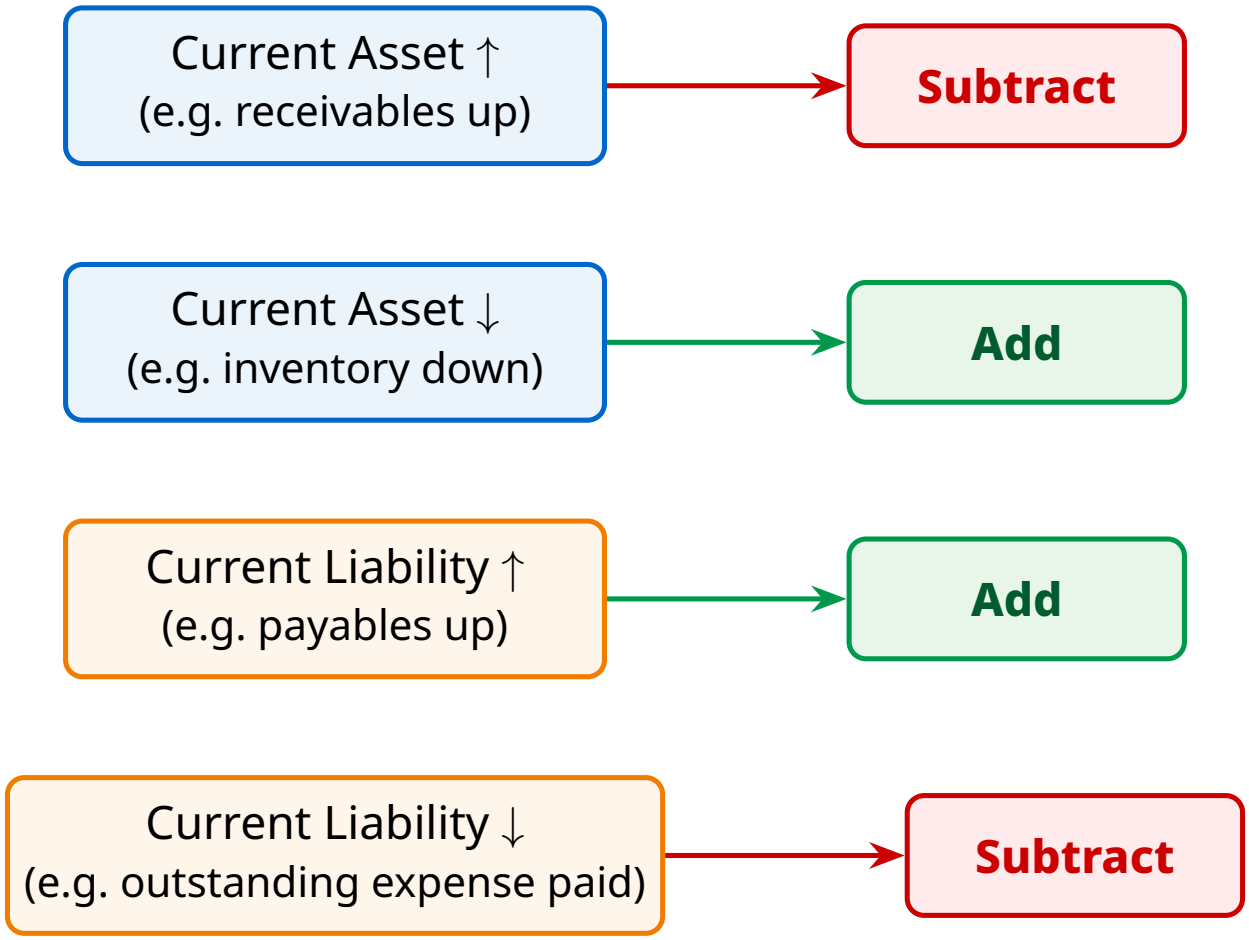
- **Profit on sale of fixed asset**, actual cash inflow appears under investing.
- **Interest received** and **dividend received** on investments, for a non-financial firm these are investing inflows, not operating.
- **Income-tax refund**, usually shown as an investing/financing adjustment depending on classification of the originating tax.

## 5.6 Step 4: Adjust for Working-Capital Changes

Working capital comprises current assets (other than cash and cash equivalents) and current liabilities. The logic is mechanical:

- **Increase in a current asset** (e.g. trade receivables go up) means *cash was tied up* in that asset, **subtract**.
- **Decrease in a current asset** (e.g. inventories run down) means *cash was released*, **add**.

- **Increase in a current liability** (e.g. trade payables go up) means *cash was retained* (supplier financed us), **add**.
- **Decrease in a current liability** (e.g. outstanding expenses paid off) means *cash was used*, **subtract**.




*Working-capital sign chart: when in doubt, "cash tied up" means subtract, "cash released" means add.*

**Quick Tip**

Two-line mental rule for working-capital signs: "**Asset and cash move opposite; liability and cash move together**." If receivables go up, cash goes down. If payables go up, cash goes up.

## 5.7 Step 5: Subtract Tax Paid

Tax **paid** during the year (not tax *provided*) is an operating outflow. Reconstruct it from the Provision for Taxation account:

$$\text{Tax Paid} = \text{Opening Provision} + \text{Provision made this year} - \text{Closing Provision}.$$

**Common Mistake**

"Provision for Tax" on the P&L (a debit-side entry) and "Tax Paid" (cash outflow) are two different numbers. Add the provision back at Step 2, then subtract the cash tax paid at Step 5. Confusing the two is the single most common error in Cash Flow questions.

## 6 Worked Illustration, Operating (Indirect)

A compressed version of the NCERT-style problem, with every line traced.

*Statement of Profit and Loss for the year ended 31 March 2020 (extract):*

- Revenue from Operations: Rs. 60,000
- Other Income (Profit on Sale of Machinery Rs. 2,000 + Tax Refund Rs. 3,000): Rs. 5,000
- Cost of materials consumed: Rs. 15,000
- Employee benefits expense: Rs. 10,000
- Depreciation & amortisation (Depn Rs. 5,000 + Goodwill Rs. 2,000): Rs. 7,000
- Other expenses (Rent Rs. 10,000 + Loss on sale of equipment Rs. 3,000): Rs. 13,000
- **Profit before Tax: Rs. 20,000**; Provision for Tax: Rs. 8,000; **Profit after Tax: Rs. 12,000**.

*Movement in working capital:*

- Trade receivables Rs. 15,000 $\rightarrow$ Rs. 21,000
- Inventories Rs. 25,000 $\rightarrow$ Rs. 22,000
- Trade payables Rs. 21,000 $\rightarrow$ Rs. 25,000
- Rent payable Rs. 2,000 $\rightarrow$ Rs. 2,500
- Provision for Taxation Rs. 10,000 $\rightarrow$ Rs. 13,000

## 6.1 Solution, step by step

| | |
|---|---|
| **Net Profit before Tax** (Profit after tax Rs. 12,000 + Provision for tax Rs. 8,000 − Income-tax refund Rs. 3,000 routed via Other Income) | Rs. 17,000 |
| *Add: Non-cash and non-operating debits* | |
| + Depreciation | Rs. 5,000 |
| + Goodwill amortised | Rs. 2,000 |
| + Loss on sale of equipment | Rs. 3,000 |
| *Less: Non-operating credits* | |
| − Profit on sale of machinery | (Rs. 2,000) |
| **Operating profit before working-capital changes** | Rs. 25,000 |
| + Decrease in inventories (Rs. 25,000→Rs. 22,000) | Rs. 3,000 |
| + Increase in trade payables (Rs. 21,000→Rs. 25,000) | Rs. 4,000 |
| + Increase in rent payable | Rs. 500 |
| − Increase in trade receivables (Rs. 15,000→Rs. 21,000) | (Rs. 6,000) |
| **Cash generated from operations** | Rs. 26,500 |
| − Income-tax paid (Op Rs. 10,000 + Provided Rs. 8,000 − Cl Rs. 13,000) | (Rs. 5,000) |
| + Income-tax refund received | Rs. 3,000 |
| **Net Cash from Operating Activities** | **Rs. 24,500** |

**Quick Tip**

When the question gives you Provision for Tax *both* on the P&L and on the Balance Sheet (opening and closing), you must use both: the P&L figure to compute Net Profit before Tax, and the Balance Sheet movement to compute Tax Paid. Never confuse the two.

# 7 Investing Activities, Worked Treatment

The investing block is almost always built around two ledger reconstructions: **Fixed-Asset account** and **Accumulated Depreciation account**.

## 7.1 The Two-Ledger Drill

Whenever the question gives an opening and closing balance of any fixed asset plus a snippet of additional information ("machine costing Rs. X with accumulated depreciation of Rs. Y sold for Rs. Z"), reconstruct both ledgers in T-form:

- **Machinery account**, gross block (cost). Debit side: opening balance, additions

(purchases) and profit on sale (if any). Credit side: cost of asset sold, depreciation transferred (if asset is on net basis), closing balance.

- **Accumulated depreciation account**, credit side: opening balance, depreciation for the year (from P&L). Debit side: depreciation on asset sold, closing balance.

Plug in everything you know; the missing figure (usually the purchase or the depreciation) drops out as the balancing figure.

## 7.2 NCERT Illustration 5, the Welprint case

Given:

- Machinery: Rs. 50,000 $\rightarrow$ Rs. 60,000.
- Accumulated Depreciation: Rs. 25,000 $\rightarrow$ Rs. 15,000.
- A machine costing Rs. 25,000 with accumulated depreciation Rs. 15,000 sold for Rs. 13,000.

**Step A. Profit/Loss on sale.** Net book value of asset sold = Rs. 25,000 $-$ Rs. 15,000 $=$ Rs. 10,000. Sale proceeds Rs. 13,000. Profit Rs. 3,000 (transferred to P&L credit; we will remove it from operating profit and the Rs. 13,000 cash will appear here under investing).

**Step B. Reconstruct Machinery account.**

- Opening Rs. 50,000 + Purchases (?) $=$ Cost of asset sold Rs. 25,000 + Closing Rs. 60,000.
- Purchases $=$ Rs. 35,000.

**Step C. Reconstruct Accumulated Depreciation.**

- Opening Rs. 25,000 + Depreciation for year (?) $=$ Dep transferred on sale Rs. 15,000 + Closing Rs. 15,000.
- Depreciation for year $=$ Rs. 5,000. *(This Rs. 5,000 feeds back into operating activities as a non-cash add-back.)*

**Step D. Cash flow from Investing Activities:**

| | |
|---|---|
| Proceeds from sale of machinery | Rs. 13,000 |
| Purchase of machinery | (Rs. 35,000) |
| **Net cash used in Investing Activities** | **(Rs. 22,000)** |

**Two outputs from one ledger drill**

The Fixed-Asset / Accumulated Depreciation reconstruction throws off TWO numbers used in different sections: the **purchase** and **sale proceeds** live in Investing, the **depreciation for the year** feeds back into Operating as a non-cash add-back, and the **profit/loss on sale** is removed from Operating (because the cash on disposal sits in Investing). Walk this loop carefully in every question.

# 8 Financing Activities, Worked Treatment

Financing flows look like a flat list once you've classified them correctly. The trap is the same as in Investing: the question often hides the gross numbers behind a net change, and you must reconstruct a ledger.

## 8.1 The Long-Term Loan Drill, NCERT Illustration 6

Given: Long-term loans Rs. 2,00,000 $\rightarrow$ Rs. 2,50,000, and "during the year the company repaid a loan of Rs. 1,00,000".

**Don't be fooled by the net rise of Rs. 50,000.** Reconstruct the Long-Term Loan account:

- Opening (credit) Rs. 2,00,000 + New loan raised (?) $=$ Repayment Rs. 1,00,000 + Closing Rs. 2,50,000.
- New loan raised $=$ Rs. 1,50,000.

| | |
|---|---|
| Proceeds from long-term borrowings | Rs. 1,50,000 |
| Repayment of long-term borrowings | (Rs. 1,00,000) |
| **Net cash inflow from Financing Activities** | **Rs. 50,000** |

**Quick Tip**

AS-3 says "gross cash receipts and gross cash payments shall be reported separately" for both financing and investing. Showing only the net change (Rs. 50,000) is wrong, even if the arithmetic ends up identical.

## 8.2 Dividend, Interest, Buy-back Pitfalls

- **Dividend paid**, always a financing outflow. Use the previous-year proposed-dividend figure, not the current year's (proposed dividend is contingent until approved at the AGM, and gets paid in the following year).
- **Interest on debentures**, financing outflow at the coupon rate; compute on the average outstanding face value if there has been an issue or redemption during the year.
- **Buy-back of equity shares**, treat the full consideration (face value plus premium) as a financing outflow; the premium portion is debited to Securities Premium Reserve in the books, but in cash terms the entire amount leaves the company.
- **Issue of bonus shares**, non-cash transaction, ignore entirely.

# 9 Preparing the Complete Cash Flow Statement

Once each of the three sections is computed, the structure of the final statement falls out almost automatically.

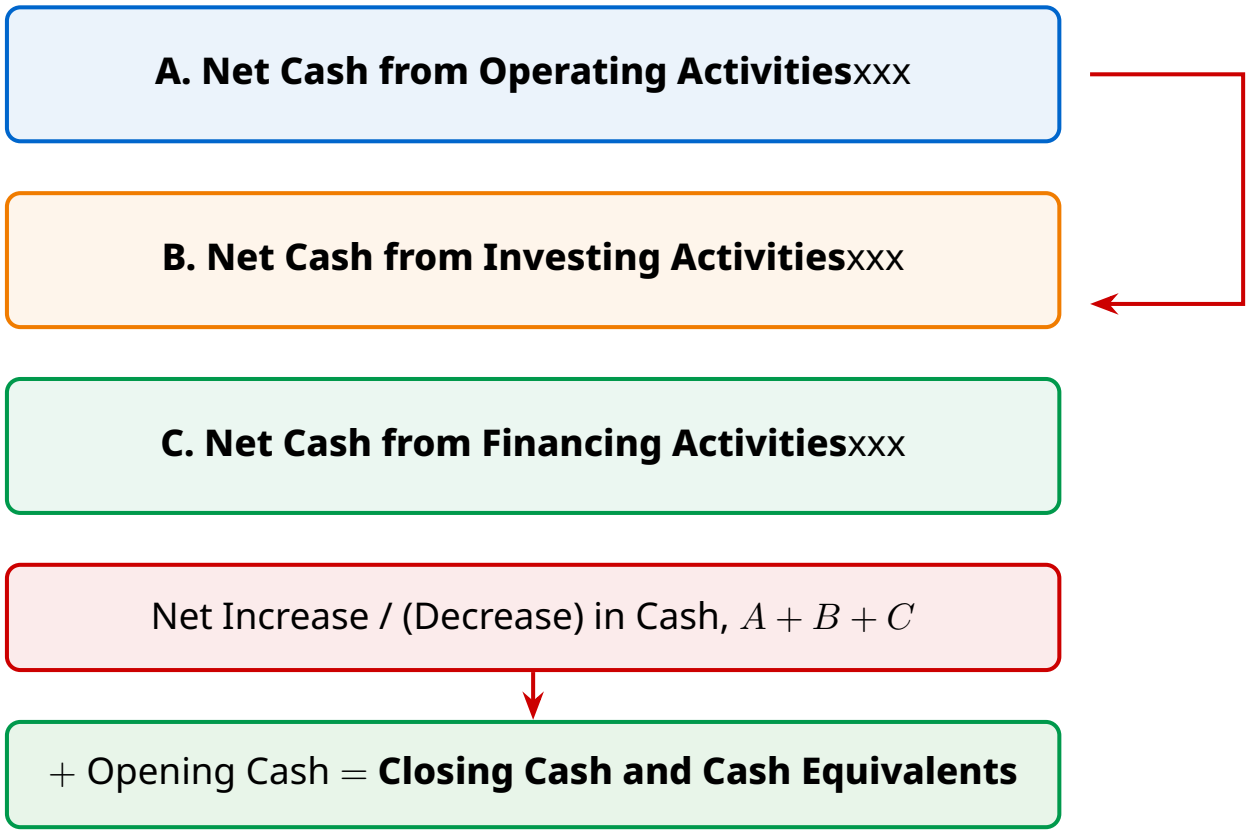
## 9.1 The Final Format

**Cash Flow Statement (Indirect Method), Summary**

| | |
|---|---|
| **A. Net Cash from Operating Activities** | xxx |
| **B. Net Cash from Investing Activities** | xxx |
| **C. Net Cash from Financing Activities** | xxx |
| Net Increase / (Decrease) in Cash and Cash Equivalents (A+B+C) | xxx |
| + Cash and Cash Equivalents at the beginning of the period | xxx |
| **Cash and Cash Equivalents at the end of the period** | **xxx** |

## 9.2 The Three-Bucket Layout, Visual

The final Cash Flow Statement is structurally three vertical bands stacked on top of each other; each band carries a net figure, and the three nets reconcile opening cash with closing cash.



*Three coloured bands stack to a single net change in cash, which reconciles opening to closing balance.*

## 9.3 The Built-in Arithmetic Check

The closing figure of cash and cash equivalents derived from the statement must exactly equal the total of cash in hand, cash at bank and cash equivalents shown in the closing Balance Sheet. If it does not, one of three things has happened:

1. A non-cash item has been treated as cash.
2. A working-capital change has been added when it should have been subtracted, or vice versa.
3. A flow has been classified under the wrong activity head (which by itself does not break the total, but pairs with other errors).

**Memory Aid**

**"OIF + Open = Close"**: Operating, Investing, Financing nets together, plus opening cash, equals closing cash. Burn this acronym in, it is the only check you need at the end of the question.

## 9.4 Worked Example, NCERT Illustration 7 (Pioneer Ltd.)

*Balance Sheet (extract, in lakh of rupees):*

| | 31-Mar-17 | 31-Mar-16 |
|---|---|---|
| Share capital | 7,00,000 | 5,00,000 |
| Reserves & surplus (Surplus in P&L) | 4,20,000 | 2,50,000 |
| 10% Bank loan (long-term) | 50,000 | 1,00,000 |
| Trade payables | 45,000 | 50,000 |
| Outstanding rent | 7,000 | 5,000 |
| Provision for taxation | 50,000 | 30,000 |
| Tangible fixed assets (Equipments + Furniture) | 5,00,000 | 5,00,000 |
| Patents (intangible) | 95,000 | 1,00,000 |
| Non-current investments | 1,00,000 | , |
| Inventories | 1,30,000 | 50,000 |
| Trade receivables | 1,20,000 | 80,000 |
| Cash and cash equivalents | 3,27,000 | 2,05,000 |

*Additional information:* Equipment costing Rs. 80,000 purchased; loss on sale of equipment Rs. 5,000; depreciation on equipment Rs. 15,000 and on furniture Rs. 30,000; bank loan Rs. 50,000 repaid; proposed dividend for 2015–16 Rs. 50,000.

**Step 1: Net Profit before Tax.**

$$\Delta\text{Surplus} = Rs.\ 4{,}20{,}000 - Rs.\ 2{,}50{,}000 = Rs.\ 1{,}70{,}000.$$

Add back current-year Provision for tax (made out of profit) Rs. 50,000 and current-year Proposed dividend Rs. 50,000.

$$\text{Net Profit before Tax} = Rs.\ 1{,}70{,}000 + Rs.\ 50{,}000 + Rs.\ 50{,}000 = Rs.\ 2{,}70{,}000.$$

**Step 2: Add back non-cash and non-operating debits.**

| | |
|---|---|
| Depreciation on equipment | Rs. 15,000 |
| Depreciation on furniture | Rs. 30,000 |
| Patents written off (Rs. 1,00,000 → Rs. 95,000) | Rs. 5,000 |
| Loss on sale of equipment | Rs. 5,000 |
| Interest on 10% bank loan (avg Rs. 75,000 $\times 10\%$ approx, NCERT uses Rs. 10,000) | Rs. 10,000 |
| **Operating Profit before WC changes** | **Rs. 3,35,000** |

**Step 3: Working-capital adjustments.**

| | |
|---|---|
| − Decrease in trade payables (Rs. 50,000 → Rs. 45,000) | (Rs. 5,000) |
| + Increase in outstanding rent (Rs. 5,000 → Rs. 7,000) | Rs. 2,000 |
| − Increase in trade receivables (Rs. 80,000 → Rs. 1,20,000) | (Rs. 40,000) |
| − Increase in inventories (Rs. 50,000 → Rs. 1,30,000) | (Rs. 80,000) |
| **Cash generated from operations** | **Rs. 2,12,000** |
| − Tax paid (Op Rs. 30,000 + Provided Rs. 50,000 − Cl Rs. 50,000) | (Rs. 30,000) |
| **A. Net Cash from Operating Activities** | **Rs. 1,82,000** |

**Step 4: Investing block.**

| | |
|---|---|
| Proceeds from sale of equipment (Cost paid $Rs.\ 80{,}000 - \Delta\text{Tangible}\,0 - \text{Dep on eq.} - \text{Loss working}$) | Rs. 30,000 |
| Purchase of equipment | (Rs. 80,000) |
| Purchase of non-current investments | (Rs. 1,00,000) |
| **B. Net Cash used in Investing Activities** | **(Rs. 1,50,000)** |

**Step 5: Financing block.**

| | |
|---|---|
| Issue of equity share capital (Rs. 5,00,000 → Rs. 7,00,000) | Rs. 2,00,000 |
| Repayment of bank loan | (Rs. 50,000) |
| Dividend paid (previous year's proposed) | (Rs. 50,000) |
| Interest on bank loan | (Rs. 10,000) |
| **C. Net Cash from Financing Activities** | **Rs. 90,000** |

**Final check.**

$$A + B + C = Rs.\ 1{,}82{,}000 - Rs.\ 1{,}50{,}000 + Rs.\ 90{,}000 = Rs.\ 1{,}22{,}000.$$

$$\text{Opening cash} + Rs.\ 1{,}22{,}000 = Rs.\ 2{,}05{,}000 + Rs.\ 1{,}22{,}000 = Rs.\ 3{,}27{,}000.$$

This matches the closing cash on the Balance Sheet, the statement balances. ✓

**Real-World Application**

Pioneer's operating cash of Rs. 1.82 lakh exceeds the dividend of Rs. 0.5 lakh and the loan repayment of Rs. 0.5 lakh combined, the firm is self-financing its payouts. But it also raised Rs. 2 lakh of fresh equity to fund a Rs. 1 lakh investment and to pile up an extra Rs. 1.2 lakh of cash. A capital-rich growth posture.

# 10 Direct Method, Brief Treatment

While the syllabus emphasis is on the indirect method, AS-3 actively encourages the direct method because it discloses the underlying gross flows. CBSE has historically asked one short question on direct-method preparation.

## 10.1 The Direct Format

**Cash from Operating Activities (Direct Method)**

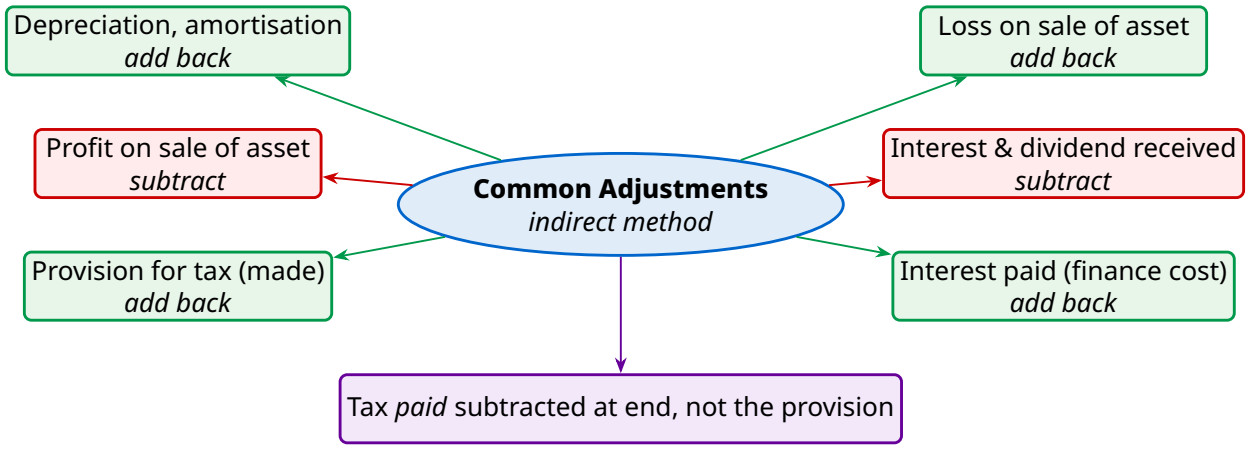
| | |
|---|---|
| Cash receipts from customers (Revenue $\pm\Delta$ Trade Receivables) | xxx |
| $-$ Cash paid to suppliers and employees (COGS, salaries $\pm\Delta$ WC) | (xxx) |
| Cash generated from operations | xxx |
| $-$ Income-tax paid | (xxx) |
| $\pm$ Effect of extraordinary items | xxx |
| **Net Cash from Operating Activities** | **xxx** |

## 10.2 Converting accrual to cash, four standard formulae

| Item | Cash equivalent |
|---|---|
| Revenue from operations | Revenue + Opening Receivables $-$ Closing Receivables |
| Purchases (accrual) | Purchases + Opening Payables $-$ Closing Payables |
| Operating expenses (accrual) | Expense + Opening Outstanding $-$ Closing Outstanding $-$ Opening Prepaid + Closing Prepaid |
| Income tax expense | Provision opening + Provided for year $-$ Provision closing |

The two methods will always converge to the same Net Cash from Operating Activities, different paths, same destination.

# 11 Common Pitfalls and Exam Tips




*Green leaves are add-backs, red leaves are subtractions, purple is the procedural exception (tax).*

## 11.1 Sign Errors, the Top Five

1. Forgetting to *add back* loss on sale of an asset, or forgetting to *subtract* profit on sale.
2. Mixing up "Provision for Tax made" (added back at Step 2) with "Tax Paid" (subtracted at Step 5).
3. Using **current** year proposed dividend as cash outflow, the current-year proposed dividend has not yet been paid in cash; only the **previous** year's dividend, approved at the AGM, is paid this year.
4. Treating an increase in current asset as an addition.
5. Misclassifying interest paid as an operating outflow (it is financing for a non-financial enterprise).

## 11.2 Items Excluded from CFS

- Bonus issue of shares (book entry, no cash).
- Conversion of debentures into equity (non-cash).
- Acquisition of an asset in exchange for shares (non-cash, disclose separately).
- Revaluation surplus on fixed assets (book entry, no cash).
- Transfer to reserves out of P&L surplus (internal earmarking, no cash leaves).

### 11.3 Items Often Mis-classified

| Item (non-financial firm) | Correct head |
|---|---|
| Interest paid on debentures | Financing outflow |
| Interest received on investments | Investing inflow |
| Dividend paid on equity / preference | Financing outflow |
| Dividend received on shares held | Investing inflow |
| Bank overdraft / Cash credit | Financing (movement during year) |
| Sale of stock-in-trade (inventory) | Operating inflow |
| Sale of office building (fixed asset) | Investing inflow |
| Capital gains tax on sale of building | Investing outflow |
| Dividend distribution tax | Financing outflow |
| Income-tax on operating profit | Operating outflow |

**Common Mistake**

"Bank overdraft" looks like a current liability, so students subtract it from cash. But AS-3 (Indian) treats bank overdraft as a **financing activity** (the actual increase/decrease in OD during the year is a financing flow). Under IFRS the treatment differs, overdraft repayable on demand is treated as a component of cash equivalents. The NCERT exam uses the Indian-AS treatment.

## 12 JEE / Competitive Aptitude Extensions

While Cash Flow Statement is mainly a CBSE board topic, CUET, CA Foundation, CMA Foundation and university aptitude tests routinely ask MCQs on it. The extensions below cover what those papers add to NCERT.

### 12.1 Free Cash Flow

Several Indian commerce papers and the CFA-style MCQs ask for **Free Cash Flow to the Firm (FCFF)** or **Free Cash Flow to Equity (FCFE)**, neither of which is in NCERT but both of which build directly on the CFS:

**Free Cash Flow**

$$\text{FCFF} = \text{Net Cash from Operations} - \text{Capital Expenditure}$$
$$\text{FCFE} = \text{FCFF} - \text{Net Borrowing Repayments} - \text{Interest paid (after tax)}$$

Both numbers are recoverable directly from the three sections of a CFS, so the typical exam question gives a CFS and asks you to compute one or the other.

## 12.2 Quality of Earnings Ratio

A higher ratio of operating cash flow to net income signals "high-quality" earnings, profits that are converting to cash rather than getting stuck in receivables or inventory.

**Earnings Quality**

$$\text{Earnings Quality Ratio} = \frac{\text{Net Cash from Operating Activities}}{\text{Net Profit after Tax}}$$

A ratio below 1 over multiple years is a red flag; above 1.2 indicates strong conversion. Profitable firms with ratios persistently below 0.5 are classic suspects for receivables-based revenue inflation.

**Real-World Application**

When Infosys publishes its annual report, the segment that financial analysts copy into Excel first is the Cash Flow Statement, not the Statement of Profit and Loss. Operating cash of roughly Rs. 25,000 crore against PAT of about Rs. 24,000 crore (FY-2024) signals a near-1.0 conversion ratio, healthy and stable. Compare that with a real-estate developer where operating cash often runs negative even when reported profit is positive, because revenue stays trapped in WIP and customer-advances.

## 12.3 Common MCQ Trap, "cash flow from operations" vs "profit"

Multiple-choice items frequently set up a scenario, depreciation Rs. X, profit on sale of asset Rs. Y, increase in receivables Rs. Z, and ask you to compute operating cash. Walk the standard indirect-method ladder; do not let the high non-cash charges in the scenario rattle you.

## 12.4 Comparing CFS to Fund Flow Statement

Older textbooks (and a handful of CMA/CA papers) still ask the distinction. Fund Flow looks at change in *working capital*; Cash Flow looks at change in *cash and cash equivalents*. CFS is now the AS-mandated standard, Fund Flow has been phased out of the syllabus but turns up in conceptual MCQs.

| Aspect | Cash Flow Statement | Fund Flow Statement |
|---|---|---|
| What is tracked | Cash & cash equivalents | Working capital |
| Basis | Cash basis | Accrual basis (working-capital basis) |
| Heads | Operating, Investing, Financing | Sources & Applications of funds |
| Standard mandate | AS-3, Companies Act 2013 | Not mandated under current AS |
| Primary user | Liquidity analyst | Long-term capital analyst |

# 13 Quick Reference Summary

## 13.1 The Three Buckets at a Glance

**Operating**, cash from the core trade. Indirect method: start with NP before tax, add non-cash charges, subtract non-operating gains, adjust working capital, subtract tax paid.
**Investing**, cash on long-term assets and investments. Sale of fixed asset is an inflow; purchase is an outflow. Interest and dividend *received* sit here for a non-financial firm.
**Financing**, cash on capital structure. Issue of shares and debentures is an inflow; repayment, redemption, buy-back, interest *paid* and dividend *paid* are outflows.

## 13.2 One-Page Formula Sheet

**Operating Activities (Indirect)**

$$\text{NCFO} = \text{NPBT} + \text{Non-cash charges} + \text{Non-op losses} - \text{Non-op gains} \pm \Delta\text{WC} - \text{Tax paid}$$

**Activity Sums**

$$\text{Net change in cash} = \text{NCFO} + \text{NCFI} + \text{NCFF}$$

$$\text{Closing cash \& equivalents} = \text{Opening cash} + \text{Net change in cash}$$

**Direct-method conversions**

$$\text{Cash from customers} = \text{Revenue} + \text{Opening Rec.} - \text{Closing Rec.}$$

$$\text{Cash to suppliers} = \text{Purchases} - \text{Opening Pay.} + \text{Closing Pay.}$$

$$\text{Tax paid} = \text{Opening Prov.} + \text{Provided for year} - \text{Closing Prov.}$$

## 13.3 Glossary, Ten Terms

| | |
|---|---|
| Cash | Cash in hand and demand deposits with banks. |
| Cash equivalents | Short-term ($\leq$ 3 months), highly liquid investments with insignificant value risk. |
| Cash flow | Inflow or outflow of cash and cash equivalents. |
| Operating activities | Principal revenue-generating activities. |
| Investing activities | Acquisition / disposal of long-term assets and non-current investments. |
| Financing activities | Activities that change the size and composition of owners' capital and borrowings. |
| Direct method | Operating cash by listing gross receipts and payments. |
| Indirect method | Operating cash by adjusting net profit for non-cash and non-op items. |
| Non-cash transaction | Book entry with no cash movement (e.g. bonus shares, conversion). |
| Extraordinary item | Non-recurring item (theft, flood, insurance claim); disclosed separately. |

## 13.4 Likely Exam Questions

- **1 mark.** Classify "interest paid on debentures by a manufacturing company", *Financing outflow.*
- **1 mark.** Will "Sale of marketable securities (maturity 60 days)" be shown in CFS?, *No, it is a cash equivalent; the transaction is an internal shuffle.*
- **3 marks.** Compute Cash from Operating Activities given a P&L extract and a working-capital movement table.
- **4 marks.** Compute Cash from Investing Activities from opening/closing fixed assets and one sale during the year (the standard ledger reconstruction).
- **6 marks.** Prepare a complete Cash Flow Statement from two balance sheets and notes, the staple long question on every paper.

## Related Collegedunia Resources

**Same chapter — other resources:**

- NCERT Solutions
- Formula Sheet
- NCERT Book PDF
- Handwritten Notes

**Continue learning:**

- Ch 8: Analysis of Financial Statements
- Ch 10: Cash Flow Statement
- Class 12 Accountancy — All Chapters