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IMPORTANCE OF FUND FLOW STATEMENT IN FINANCIAL DECISION MAKING OF BUSINESSES

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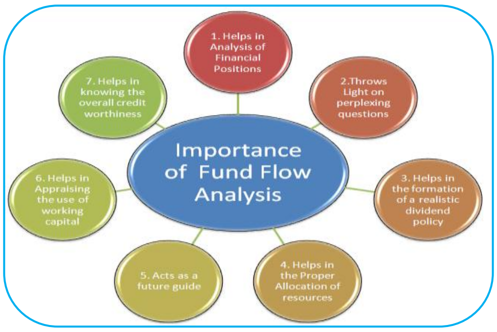
ABSTRACT:-

Fund Flow Statement can reveal the strength and weakness in utilization of available fund for business purpose. To verify the transfer of funds from the previous financial year to the current financial year, a Funds Flow Statement is a financial document which analyses a company's balance sheet for two years. It will assess the source of inflows and outflows during the relevant accounting period, as well as analyse their impact on the working capital of an organisation. It is one of the critical indicators that shows how funds are used. Finance analysts will be able to evaluate the fund flow of an organisation in due course under this statement. It is also known as the application of the Funds and the Statement of Sources, as this statement describes the movement of funds between different sources and their applications. The preparation of these statements usually follows an analysis of the flows of funds. As a financial instrument, it helps companies manage their finances and better account for the use of funds.



KEY WORDS: *Applications of Funds, Fund Flow Statement, Sources of Funds.*

INTRODUCTION:-

The term "flow of funds" means "Transfer of economic values from one asset to another and one liability to another ." Flow of fund takes place whenever there is change in working capital. This change may be either inflow or outflow of funds.

For example,

- Fixed asset changes into current asset or current asset changes into fixed assets.
- Fixed liability changes into current liability or current liability changes into fixed liability.
- Any transaction which attracts one current account and one non-current account then only it is flow of fund. Funds flow statement is a method by which we study changes in the financial position of a business enterprise between beginning and ending financial statement dates. It is a statement showing sources and uses of funds for a period of time.
- Examples of Current Assets are:
- Cash in hand
- Cash at bank
- Bills receivables
- Stock

- Debtors
- Prepaid expenses
- Accrued income
- Marketable securities
- Examples of Current Liabilities are:
- Bills payable
- Creditors
- Outstanding expenses
- Advance income

There is a direct relation between current assets and working capital. When current assets increase, working capital also increases. When current assets decrease, working capital also decreases.

Managing working capital and funding effectively is essential for any business. It is vital to keep a tab on the inflow and outflow of funds in the business. A funds flow statement is a document that helps identify the sources of funds that come into a company and how those funds are used. Let us understand what is funds flow statement and how it is calculated. A fund flow statement is a type of financial statement that shows the sources and uses of funds over a given period. It is an essential tool for financial analysis because it provides insights into a company's financial health and ability to generate and use cash. The fund flow statement is prepared by comparing the balance sheets of two consecutive periods.

Objectives of Fund Flow Statement

The primary objectives of the fund flow statement are as follows.

1. An analysis of the company's operating situation

The balance sheet provides an overview of the company's finances constantly. This report provides an overview of the company's situation at any given time. Hence, it is essential to undertake a detailed examination of funds movements to improve corporate finance planning.

2. Help to inform the company of changes in its financial position

A statement of reasons for changing the assets, liabilities or equity capital shall be essential in preparing a Fund Flow Statement. This is based on comparing the two balance sheets for different accounting periods.

3. Help to allocate the resources in a proper manner

To make more efficient and effective use of resources, the financial flow declaration helps provide information on resource allocation. It also includes information on the source of financing from abroad and internal sources.

4. To assess whether or not the company is financially stable

Fund flow statements are required to determine the strengths and weaknesses of the company's external and internal users of the financial statements.

5. The future guidance will be the fund flow statement

The fund flow statement shall reflect all details relating to the historical changes in the company's working capital and assets in a particular accounting period. Therefore, it is an instrument for making budgetary decisions to meet the organisation's objectives.

Components of Fund Flow Statement

The main components of a Fund Flow Statement are:

- Sources of Funds

- Applications of Funds

Sources of Funds

Sources of funds section of the Fund Flow Statement represents the inflow of funds or the sources from which funds have been generated. It includes the following components:

- **Net Profit or Loss from Operations**: This is the net income generated from the company's core business operations and is a primary source of funds.
- **Depreciation**: Although not an actual cash expense, depreciation is also added because it represents a non-cash expense that reduces the net profit.
- **Issue of New Shares or Debentures:** Funds raised through the issuance of new equity shares or debentures represent an inflow of funds.
- **Sale of Non-Current Assets**: Funds generated from the sale of long-term assets, such as property or investments, are included as sources of funds.
- **Decrease in Working Capital**: Reducing the company's working capital (current assets minus current liabilities) is also a source of funds.

Applications of Funds

This section of the Fund Flow Statement represents the outflow of funds or the uses to which funds have been applied. The application of funds includes -

- **Investing activities**: Funds used for acquiring long-term assets, such as property, plant, and equipment, are considered applications of funds.
- **Repayment of Long-Term Debt**: Payments made to reduce long-term debt obligations are considered uses of funds.
- **Payment of Dividends**: Dividend payments to shareholders represent an outflow of funds.
- **Increase in Working Capital**: An increase in working capital resulting from an increase in current assets or a decrease in current liabilities indicates an application of funds.
- **Redemption of Shares or Debentures**: Funds used to buy back or redeem shares or debentures are considered applications of funds.
- **Change in Cash and Cash Equivalents:** This section summarises the net change in cash and cash equivalents during the period. It combines the sources and applications of funds to calculate the overall change in cash and cash equivalents.
- **Closing Cash and Cash Equivalents:** This is the ending balance of cash and cash equivalents after considering the net change during the period.

Preparation of Fund Flow Statement

Step 1: Preparation of Statement of Changes in Working Capital: Statement of Changes in working capital is a summary that shows the net increase or decrease in the working capital of the business. The working capital of the firm increases if there is an increase in the current assets or decrease in the current liabilities. However, the working capital of the firm decreases if there is a decrease in the current assets and an increase in the current liabilities. Further, there will be no change in the working capital if there is a realization from debtors or bills receivable or payment made to creditors or bills payable, goods are sold on credit and goods are purchased on credit.

Step 2: Determination of Funds from Operations: Funds from operations refers to the profit earned or loss incurred from the regular business operation. The ascertainment of funds from the operation is vital for the preparation of fund flow statement.

Step 3: Preparation of Fund Flow Statement: After recognizing the funds/loss from operations, fund flow statement is prepared, which will show the net increase or decrease in the working capital. Basically, any change in the assets and liabilities may result in the inflows and outflows of funds, but not always, as in case of depreciation or revaluation of assets, there is no inflow or outflow of funds. Hence, only those assets or liabilities will become a part of the statement, which actually leads to the flows of the fund to/from the business.

Importance of Funds Flow Statement

The following are the uses and significance of fund flow statement:

- **Financial Position**: A profit and loss statement or balance sheet does not explain the reasons for the change in a company's financial position. The statement will give information about where the funds have come (Source of Funds) and where the funds have been used (Application of Funds).
- **Company Analysis**: Often, companies that are making profits end up in cash crunch scenarios. In such scenarios, the funds flow statement offers a clear picture of the source and usage of funds.
- **Management**: The funds flow statement assists management in determining its future course of action and also serves as a management control tool.
- **Changes in Assets and Liabilities**: The statement shows the reason behind the change in assets and liabilities between two balance sheet dates. As a result, you can conduct an in-depth analysis of the balance sheet.
- **Creditworthiness**: Lending institutions use this statement of a company to analyse creditworthiness. They compare the statement over the years before approving a loan. Therefore, the statement depicts a company's credibility in terms of fund management.

Limitations of Funds Flow Statement

Despite its importance in analyzing the financial position of a firm, the following are the limitations of fund flow statement:

The statement focuses only on the movement of funds. It doesn't consider other parameters that are part of the Balance Sheet and Profit and Loss Account. Therefore, it has to be analyzed alongside the Balance Sheet and Profit and Loss Account.

The funds flow statement doesn't depict the cash position of a company. Hence, a separate cash flow statement has to be made for analyzing the cash position.

Effective Working Capital Management Strategies

- To manage working capital effectively based on fund flow analysis, businesses can implement various strategies:
- Optimizing Inventory Levels: By controlling inventory levels, companies can reduce excess stock holding costs and free up cash for other purposes.
- Streamlining Accounts Receivable: Accelerating the collection of accounts receivable can enhance cash inflows and improve overall liquidity.
- Negotiating Supplier Terms: Negotiating favourable payment terms with suppliers can help extend payment periods and preserve cash reserves.
- Monitoring Cash Conversion Cycle: Tracking the cash conversion cycle closely allows businesses to identify bottlenecks and streamline processes for quicker fund availability.
- Utilizing Short-Term Financing: Quick access to funds during times of need can be leveraged using short-term borrowing options without affecting long-term financial stability.

CONCLUSION

Fund flow statements are a valuable tool for understanding a company's financial performance and ability to generate and use cash. Fund flow statements can be prepared on a monthly, quarterly, or annual basis. They can be used by investors, creditors, management, and financial analysts to make informed decisions.

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