

Cash Flow Statement Disclosures in Pharmaceutical Companies: Bangladesh Perspective

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Abstract

Cash flow statement is a vital part of the financial statements. Preparation of cash flow statement is required as per Companies Act 1994 and the public limited companies enlisted with stock exchange are to prepare this statement as per other statutory laws and regulations. The acceptance of International Accounting Standard- 7: Cash Flow Statement has added a new dimension to the preparation and presentation of financial statements in Bangladesh. The companies are now preparing this statement as an integral part of their financial statements. This paper examines empirically the current practices followed by sample companies in preparation of cash flow statement and concludes that the sample companies are in line (with few exceptions) with the requirements of International Accounting Standard (IAS)-7 or Bangladesh Accounting Standard (BAS)-7. It also proposes some suggestions for improving the presentation of the statement

Key words: Cash flow statement, IAS/BAS, Listed Company, Disclosure.

Introduction

The purpose of a cash flow statement is to provide information on the cash flow from a company's operating, investing and financing activities to enable the users of its financial statements to evaluate the ability of the company to generate cash and to use the historic cash flows to predict future cash flows. The cash flow information enhances the comparability of the operating performance by various companies, because it eliminates the effects that arise from the use of different accounting treatments for the same transactions and events.

The use of cash flow information is gaining importance in the analysis of financial statements (Epstein 1991; Yap 1997; Jones and Widjaja 1998; Previts and Bricker 1994). Cashflow information is considered less open to manipulation than information on earnings, because it is based on the actual receipt and payment of cash only and not on the accrual and other accounting principles. Rees (1995:75) adds that the cash flow statement can be more informative than the other statements. However, the literature on the cash flow statement indicates that there are grey areas in cash flow reporting that are open to various interpretations (Everingham and Watson 2002). The perceived simplicity of the cash flow statement may therefore create synthetic confidence in the reliability of companies' cash flow reporting and the comparability of various companies' cash flow information. The acceptance of IAS-7: The Cash Flow Statement has added a new dimension to the preparation and presentation of financial statements in Bangladesh. This paper is an attempt to investigate into the state of cash flow reporting by the listed Bangladeshi

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Textiles and Clothing companies in general. The focus is not on the quality of the reporting of the companies but rather on what the reporting levels are in general.

Objectives of the study

The major objectives of the study are as follows:

1. to identify the current practice of cash flow statement of Pharmaceutical companies in Bangladesh.
2. to provide present cash flow statement format, structure and reporting on the basis of information provided in the annual reports of the selected listed Pharmaceutical companies in Bangladesh.

Methodology of the study

The study was conducted in accordance with secondary information obtained from various sources. The overview of standardization of financial reporting and the regulatory framework has been based on laws, regulation, and guideline and also on various published sources of information taken from International Accounting Standard Board (IASB) and Bangladesh Accounting Standard 7 (BAS 7). A limited survey has also been made covering a total of 12 Pharmaceutical companies' annual reports (2009) enlisted in Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE). These are selected on the basis of convenience sampling procedure. In order to make the study more revealing it also covers some research articles, textbooks, publications and web sites of various accounting bodies.

Limitations of the study

1. Applied non profitability techniques have been used.
2. Due to limitation of the extensive materials, books and previous studies in Bangladesh literature review could not be extensive.
3. This study consists of only 12 listed Pharmaceutical companies due to time and resources constraints.

Literature review

Cash flow statement: A historical surroundings/background

Cash flow Accounting (CFA) was the main system of accounting up to beginning of the 18th century (Watanabe, Izumi: *The evolution of Income Accounting in Eighteenth and Nineteenth Century Britain*, Osaka University of Economics, Vol.57, No. 5, January 2007, p.27-30). Till then, accounting allocation and profit measurement were relatively unimportant; the profit and loss account being used to close off ledger accounts at each period end. However, with the advent of concept and practices of business continuity, periodic measure and statement of financial position began to grow. Thus the basis of cash transaction becomes foundation for the allocation based systems of accounting today. Although there has been a reasonably sustained interest in fund flow statements (based on allocated accounting data) since the beginning of the twenty century, CFA appears to have received little or no support from accountants until the early 1960s. At that time there was little concern over the use of 'cash flow' data in the financial analysis- cash flow being interpreted as 'profit plus depreciation' (Winjum, J.o, 1972). In 1961 AICPA recognized the importance of fund statement by publishing Accounting Research Study (ARS)

NO 2 “Cash flow analysis and fund statements”. Before that, accountants had prepared funds statements primarily as management report. The Accounting Principles Board (APB) responded in October 1963 by issuing APB Opinion NO. 3: “the statements of and application of funds”, which recommended that a statement of sources and application of funds be presented on a supplementary basis. Because of the favorable response of the business community to this pronouncement, the APB issued Opinion No. 198: “Reporting changing in Financial Position” in March 1971. This opinion required that a statement of changing financial position be presented as a basic financial statement and be covered by the auditor’s reports.

In 1981 the Financial Accounting Standard Board (FASB) reconsidered fund flow issues as part of the conceptual framework project taken in 1976. At this time the FASB decided that the cash flow reporting issues should be considered at the standard level. Subsequent deliberation resulted in Statement of Financial Accounting Standard (SFAS) No. 95: ‘Statement of cash flows’ in November 1987 (Weygandt, Kieso, Kimmel 1998: 1936).

Fund flow statement Vs Cash flow statement

Both fund flow statement and cash flow statement serve as a fundamental parts of the financial statements. In 1961, the AICPA issued ARS No. 2, “*Cash Flow Analysis and the Fund Statements*” which recommended that a fund statement covered by auditor’s opinion be included in companies financial reports. According to paragraph 5 of Preface to Statement of International Accounting Standard [approved by the IASC Board in November 1982 for publication in January 1983 and supersedes the preface published in January 1975 (amended March 1978)], “the term ‘financial statements’ covers balance sheets, income statement or profit and loss accounts, *statements of change in financial position*, notes and other statements and explanatory materials which are identified as being part of financial statements” (IASC, 2000:32). As per paragraph 7 of framework for *the Preparation and Presentation of Financial Statements* (approved by IASC Board in April 1989 for publication in July 1989): “A complete set of financial statement normally includes a balance sheet, an income statements, a statements of change in financial position (which may be presented in a variety of ways, for example as *a statement of cash flow* or *a statement of fund flows*) and those notes and other statements and explanatory materials that are an integral part of the financial statements” (IASC : p. 43-44).

As per paragraph 4 of the previous IAS 7 (October 1977), *statements of change in financial position*, the term ‘*funds*’ referred to cash, cash and cash equivalents or working capital (IFAC, 1992: p.813). Funds provided or used in operation of an enterprise should be presented in the statements of changes in financial statement separately from other sources and uses of fund. Unusual items, which are not part of ordinary activities of the enterprise, should be separately disclosed (IASC: Para 21). But many users of financial statements consider current practices of reporting fund flows as confusing because too much information is compressed in the statements of change in financial position, and because no single definition has been established (Mosich and Larsen, 1982; p. 935). In order to develop a conceptual framework for financial accounting and reporting, the FASB issued in December 1980 a discussion memorandum “reporting Fund flow, Liquidity and Financial Flexibility” which was issued for the following reasons: (1) for assessing future cash flow, and (2) current practices regarding the reporting of funds flow information are not entirely satisfactory. As a result of deliberation, FASB issued SFAS NO. 95 ‘*Statements of Cash Flow*’ in 1987. The statements require the inclusion of statements of Cash Flows rather than a statement of Change in Financial position when issuing a complete set of financial statements

which was made effective for annual periods ending after July 15, 1988. The major requirements of the statements are of the following two areas:

Basis of Presentation: The statement must focus on cash receipts and payments and must explain the change in cash plus cash equivalents.

Classification of cash flows: Cash flows are to be classified according to operating, investing and financing activities.

The basis of such classification is derived from the financial theory, which state that the enterprise derives the cash used for investing activities and settlement of outstanding financial obligation in an accounting period from internal and external sources. Internal cash sources emanate from the net cash generated from current operation and perhaps disinvesting and depletion of cash resources at the start of the period. External cash sources come from financing activities such as borrowing and receiving cash from the sale of equity shares to existing and new shareholders (Wallace et,al).

Benefits of Cash Flow Information

- The information in a cash flow statement helps investors, creditors, and others to assess the following aspects of the firm's financial position.
- Such statements serve as a mechanism for predicting the ability to generate future cash flows for the investors, creditors and others.
- This enables managers or management to plan coordinate and control financial operation in an effective manner.
- It gives an indication of the relationship between profitability and cash generating ability thus of the quality of the profit earned.
- It furnishes information to the management regarding the entities' ability to pay dividend and meet obligations.
- Analyst and other users of financial information often, formally or informally, develop models to assess and compare the present value of the future cash flow of entities. Historical cash flow statements could be useful to check the accuracy of past assessment (ACCA Text book part 2. P.324).
- It is free from manipulation and is not affected by subjective judgments or by accounting policies.
- Such a statement dictates situations when a business has made huge profit but has run out money or it has sustained loss but has enough cash availability.
- The extent of cash generated from operational activity and external finance in order to meet capital, tax, and dividend requirements can be obtained from such statements (Lee, T.A: 1972:27-36).
- It aids in the evaluation of risk, which includes both the expected variability of future return and probability of insolvency or bankruptcy (Hendrickson, Eldom.S, 1982: 237).
- Such statements reveal the capability of an enterprise to pay its short obligation as and when due to the lenders.
- A cash flow statement in conjunction with a balance sheet provides information on liquidity, viability, and adaptability. The balance sheet is often used to obtain information on liquidity, but the information is rather incomplete for this purpose as the balance sheet is prepared at a particular point of time.

- It may assist users of financial statements in making judgments on the amounts, timing and degree of certainty of future cash flows.
- This statement provides information that is useful in checking the accuracy of past assessment of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing price (IAS 7: Para 3 & 4).
- Information on cash flows classified by three groups of activities (Operating, investing and financing) that allow users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationship among those activities (IAS 7: Para 11).
- This statement is of special importance in assessing future cash flows, quality of income, operating capability, financial flexibility and liquidity, and information on financing and investing activities. Using cash flows from operating activities from the cash flow statements, different ratios such as liquidity ratio, solvency ratio, and profitability ratios can also be calculated to evaluate an enterprise's liquidity, solvency, and profitability. (Aziz uddin and Bala, 2001: p. 14)

Overview of Cash flow statement

The cash flow statement explains the changes that have occurred in the company's cash and cash equivalents during the year by classifying the cash flows in its operating, investing and financing activities. The statement must focus on cash receipts and payments and must explain the change in cash plus cash equivalents. The classification is done in a way that is most appropriate to the company's business. The following are the definitions of the components of the cash flow statement:

Cash: cash on hand and demand deposits

Cash equivalents: short term, highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value.

Operating activities: the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities

Investing activities: the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities: activities that result in changes in the size and composition of the equity capital and borrowings of the enterprise (Epstein, p. 93).

Objective and Scope of IAS 7

Information about the cash flow of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows. The economic decision taken by users requires an evaluation of the ability of an enterprise to generate cash and cash equivalents and timing and certainty of their generation. The objective of IAS 7 is to require the provision of information about the historical change in cash and cash equivalents of an enterprise by means of a cash flow statement that classifies cash flows during the period from operating, investing and financing activities. An enterprise should prepare a cash flow statement in accordance with the requirements of IAS 7 and should present it as an integral part of its financial statements for each period for which financial statements are prepared. Users of an enterprise's financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise activities and irrespective of whether cash can be viewed

as the product of the enterprise, as may be the case with a financial institution. Enterprises need cash for the same reason however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations and to provide return to the investors. Accordingly this standard requires all enterprises to present a cash flow (Para 1 & 3).

Presentation of Cash flow statement under IAS 7

Cash and cash equivalent:

The definition of cash and cash equivalent are central to the preparation and interpretation of cash flow statements. Cash consists of cash in hand and demand deposits, coins and notes of an organization, etc. In our country deposits in postal accounts may be termed as cash (Cooper and Ijiri, 1984: 88; Ghosh, 2001). Cash equivalents are short-term, highly liquid investments that are readily convertible into known amount of cash and which are subject to an insignificant risk of change in value. According to the definitions of paragraph 6 of IAS 7 cash comprises cash in hand and demand deposits; usually 'cash on hand' includes currency, notes, and coin in the cash box of the enterprise. It also includes prize bond, negotiable money orders, postal orders, and under posited checks, bank drafts or pay-order. Demand deposits refer to deposits in checking accounts in banks and other financial institutions that may be withdrawn without notice usually subject to deduction of outstanding check. Thus cash equivalents –

1. are short-term investments but the 'term' 'short' not clearly specified, although a period of three months and less is suggested to be taken as short term period.
2. are highly liquid investments. Here 'liquid' means having in a situation where cash equivalents are available in sufficient amount to meet obligation of payments.
3. are investments that are both: **(a)** readily convertible, to known amounts of cash and **(b)** subject to an insignificant risk of change in value. According to SFAC No. 95, the risk categorically refers to risk of change in interest rate. The short-term investments are so near their maturity that they represent insignificant risk of changes in interest rate. Examples include treasury bills, commercial papers, and money market funds purchased with cash that is in excess of immediate needs. However, although by definition, cash equivalents refer to short term highly liquid investments, they are usually held for the purpose of meeting short term cash commitments rather than for other purpose. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to insignificant risk of change in value. Therefore an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months and less from the date of acquisition. Equity investments are excluded from the cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred share acquired within a short period of their maturity and with a specified redemption date (Para 7).

Preparation of Cash flow statements

IAS 7 requires cash flows to be classified into operating, investing, and financing activities.

Example of cash flows by category

Operating Activities	
Inflows	Outflows
Receipts from customers	Payments to suppliers
Advance deposits from customers	Wages and salaries to employees
Income tax refunds	Income tax payments
Interest received on customers' notes or accounts	Other tax payments
Dividends and interest received from investments and included in determining net income	Interest paid on bank debt or bonds outstanding and included in determining net income
Investing Activities	
Cash received from sale of capital assets	Payments for purchase of capital assets
Cash from sale of debt or equity investments	Cash flows capitalized as intangible assets, such as: <ul style="list-style-type: none"> • development costs • start-up costs • capitalized interest • exploration Costs
Collection of principal on loans to others	Purchase of debt or equity securities of others
Interest and dividends received on investments and not included in determining net income	Loans extended to others
Financing Activities	
Net proceed of issuing debt or equity securities	Payment of principal on bonds or bank loans
Cash proceeds received from bank loans	Purchase of the entity's own shares
	Interest paid on bank debt or bonds outstanding and not included in determining net income
	Dividends paid to shareholders

Variations in Reporting activities for Cash flows

A. Operating or Financing activities

Transactions with different categories included in cash flows are classified in a different manner. According to IAS 7, Para 12, "A single transaction may include cash flows that are classified differently. For example, when the cash repayment of a loan includes both interest and capital the interest element may be classified as operating activities and the capital amount is classified as financing activities".

B. Operating or investing and financing activities

Some cash flows may be classified as arising from any activities such as 'interest', 'dividend' 'income tax'. The detailed provisions of these types are as follows.

Interest:

- a. For a financial institution, interest paid and interest received are usually classified as operating cash flows (para 33).
- b. For other enterprise, interest paid and interest received may be classified as operating cash flows because they enter into the determination of net profit or loss. Alternatively, interest paid may be classified as financing cash flows, because they are costs of obtaining financial resources. Interest received may be classified as investing cash flows, because they are returns on investments (para 33).

Dividend:

- a. For a financial institution, dividends received are usually classified as operating cash flow (Para 33).
- b. For other enterprise, dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss. Alternatively dividend received may be classified as investing cash flows, because they are returns on investments (para 33).
- c. Dividend paid may be classified as financing cash flows, because they are costs of obtaining financial resources. Alternatively dividend paid may be classified as component of cash flows from operating activities in order to assist users to determine the ability of an enterprise to pay dividend out of operating cash flows (para 34).

Income tax:

- a. Taxes on income arise on a transaction that gives to the cash flows that are classified as operating, investing, and financing activities in cash flow statement. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions. Therefore taxes paid are usually classified as cash flows from operating activities. However, often it is practicable to identify the tax cash flow within individual transaction that gives rise to cash flows that are classified as investing or financing activity as appropriate. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed (Para 36). In the light of SFAS 95, "Transaction that enter into the determination of net income" are defined as operating activities and hence, interest received or paid, dividend received and taxes on income are rigidly treated to arise from operating activities. Dividend to stakeholders are treated as cash outflows classified as financing activities (Keiso and Weygandt, 1998: 1275-76)

Cash flow statement Practices in Bangladesh**Regulatory Framework, in the eyes of the Companies Act 1994 (Act no. 18 of 1994):**

According to Section 183 of the Companies' Act 1994 (which came into effect from 1 January 1995), a company is required to present balance sheet, profit and loss account (income and expenditure account, in case of non profit companies). Under section 185, the balance sheet and the income statement have to be prepared according to the forms set out in Part –1 and Part –2 of Schedule XI respectively under which information on consecutive two years (concerned year and

preceding year) are to be provided. However according to note (g) of the general instruction for preparation of balance sheet (given in part –1 of schedule XI after the horizontal format of the balance sheet), “a statement of change in financial position shall be included as an integral part of the financial statements, and shall be presented for each period for which the profit and loss account is prepared”. However no specific format of cash flow statement has been prescribed in Companies Act 1994.

In the light of the Security and Exchange Rule 1987 (S.R.O No. 237-1/87 dated on 28 September 1987):

Under the provision of rule 12 (1) of the Securities and Exchanges Rules (SER) 1987(amended by the section notification No. SEC/ Section 7/SER/03/132 dated 22 october1997 published in the official gazette on 29 December 1997), the annual report to be furnished by an issuer of listed security shall include “a balance sheet, profit and loss account, cash flow statement and notes to the accounts collectively hereinafter referred to as the financial statement’. In the part III of the Schedule of the SER 1987, issues relating to interest paid on short-term borrowing, interest and dividend received income taxes are clearly guided. For example, interest paid on short-term borrowing shall be a cash outflow under operating activities; ‘interest and dividend received’ shall be a cash inflow under investing activities. And ‘interest paid on long term borrowing’ and ‘dividend paid’ shall be a cash outflow under financing activities. Under paragraph 35-36, ‘taxes on income’ should be treated as operating cash outflow unless they can be identified in financing and investing activities.

Findings of the study

To know the extent of cash flows statement reporting practices by Pharmaceutical companies, a survey has been conducted covering twelve annual reports (2009) (For detailed the name of the companies see Appendix-1). The major findings of the study are given below in terms of general variations in reporting and voluntary disclosure.

General findings

It includes the current format and structure of cash flow statement and the extent of compliance of IAS-7, followed by sample Pharmaceutical Companies in Bangladesh.

- All the sample companies prepare cash flow statement as required by IAS-7/BAS 7 adopted by the Institute of Chartered Accountant of Bangladesh and present it as an integral part of the financial statements. Notes to cash flow statement have been presented as part of the financial statements in case of all the sample companies.
- The sample companies prepare cash flow statement in vertical form and shows figure of cash flows of the current year and the previous year.
- All the sample companies’ cash flow statement contains a classification of operational, investing, and financing activities.
- The sample companies did not illustrate the policy adopted in determining the formulation of cash and cash equivalents although this is required by paragraph 36 of IAS 7.

Variation in Reporting

Another objective of the survey was to determine which alternatives, permitted by IAS-7, are used most in practice by Bangladeshi pharmaceutical companies. It is found that there are not many differences between companies in their reporting of cash flow information. This is expected because the preparation of cash flow statement does not allow for many choices, differences of interpretation or different accounting treatments. The results are set out in table 1.

Table-1 Variations in reporting
[Cash flow statement (CFS)]

Factors	Options	Number of companies
1 Notes to CFS	Separately, following the CFS	0
	Part of the notes to the financial statements	12
	Incorporated in the CFS	0
	Total	12
2 Operating activities	Direct method	12
	Indirect method	0
	Total	12
3 Interest received and Interest paid	Operating activities or no interest	12
	Financing	0
	Investing activities	0
	Total	12
4 Dividend received and Dividend paid	Financing activities or no dividends	12
	Operating activities	0
	Investing activities	0
	Total	12
5 Definition of cash and cash equivalents	Part of accounting policy note	12
	Nothing disclosed	0
	Total	12
6 Income tax	Operating activities or no tax	12
	Financing activities	0
	Investing activities	0
	Total	12

Notes to table 1

- Refer to point 2 of Table 1. According to IAS-7 and SEC Rule 1987, the enterprises are encouraged to report cash flows from operating activities using the direct method. The direct method provides information which may be useful in estimating future cash flows which is not available under the indirect method. All the sample companies followed the direct method in reporting operating cash flows. One company (Pharmaceutical Mithun Knitting & Dyeing Ltd.) discloses cash flows from operating activities under indirect method in notes of financial statements as additional information.

- Refer to points 3 & 4 of Table 1. All the companies studied have shown 'interest received and paid' under operating activities and 'interest paid on long term borrowing' and 'dividend paid' under financing activities.
- Refer to points 5 & 6 of Table 1. All the companies studied have shown "definition of cash and cash equivalents" in the notes of accounting policy and "income tax" under operating activities.

Voluntary disclosure

The survey also included an examination of any additional information that is disclosed regarding the company's cash flow which is not required by IAS-7, but which may be helpful to the user. For example, separate disclosure of cash flows increases operating capacity and cash flows that maintain operating capacity, disclosure of segmental cash flows, cash flow per share etc. The survey found no company to disclose such additional voluntary information in its cash flow statement.

Conclusion and Recommendation

A materially misstated cash flow statement, whether it is in terms of incorrect classification in the categories or numerical accuracy, can be misleading to the user and can lead to wrong decisions taken by the users of the statement. The survey has revealed that although sample companies prepare cash flow statement according to International Accounting Standard-7 (IAS-7), there is also a degree of non-compliance. It is, however, found that there are not many differences between companies in their reporting of cash flow information. This is expected because the preparation of cash flow statement does not allow for many choices, differences of interpretation or different accounting treatments. To make cash flow statement more informative and useful for users, the companies should disclose additional voluntary information such as cash flow per share in their cash flow statements. Items consisting of cash flows from operating, investing and financing activities should also be clarified in the notes of the financial statements. Due to the limited scope of the present study, a large number of research issues have not been attempted but are identified in the course of the study. Disclosure practices of additional items other than operating, investing and financing activities, disclosure practices differences between listed and unlisted companies, disclosure practices differences between financial and other institutions are some such potential issues for future research.

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Appendix-1**List of the twelve Pharmaceutical companies studied.**

1. GlaxcoSmithKline Bangladesh Limited (2009)
2. The IBN SINA Pharmaceutical Industry Ltd. (2009)
3. BEXIMCO PHARMACEUTICAL LTD. (2009)
4. ORION INFUSION LTD. (2009)
5. ACI Formulation Limited (2009)
6. Ambee Pharmaceutical Limited (2009)
7. Square Pharmaceutical Ltd. (2009)
8. Libra Infusions Limited (2009)
9. BEACOM Pharmaceuticals Limited (2009)
10. Rahman Chemicals Limited (2009)
11. Renata Limited (2009)
12. Therapeutics (Bangladesh) Limited (2009)