Financial Accounting
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Lecture – 14
Cash Flow Statement 1

Dear students, Namaste, today we are going to start one very exciting and new topic that is titled as Cash Flow Statement. If you remember there are three important statements in an annual report which are mandatory for all the companies and in fact, they are required for almost all the undertakings. Do you remember what are the three statements? The first one going by how we have learnt it is balance sheet, then profit and loss account and the third one is cash flow statement. In the first session, we had seen the purposes of each of these statements. So, can you tell what does the balance sheet tell you?

Balance sheet is a statement of financial position. So, it lists the assets and liabilities as on a particular date. A profit or loss account is a statement showing incomes and expenses, the net result is profit or loss for a particular period. Traditionally, these two statements were considered as the final statements showing the results of any entity. Entity can be of any type it may be profit making or non-profit making or it can be a partnership firm or say proprietary concern or a corporate; almost every undertaking had to prepared these two statements.

Gradually, it was realized that these two statements though are very important; they do not give all the information which is required by the stakeholders because stakeholders are equally interested in knowing about the movement of cash in the entity. So, a third statement was made mandatory in 90's and that is known as cash flow statement. So, today we are going to discuss the cash flow statement and we will also take a look at a few cases involving cash flow statement ok.

So, these are the contents.

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And we are going to discuss various topics as are listed in the index.

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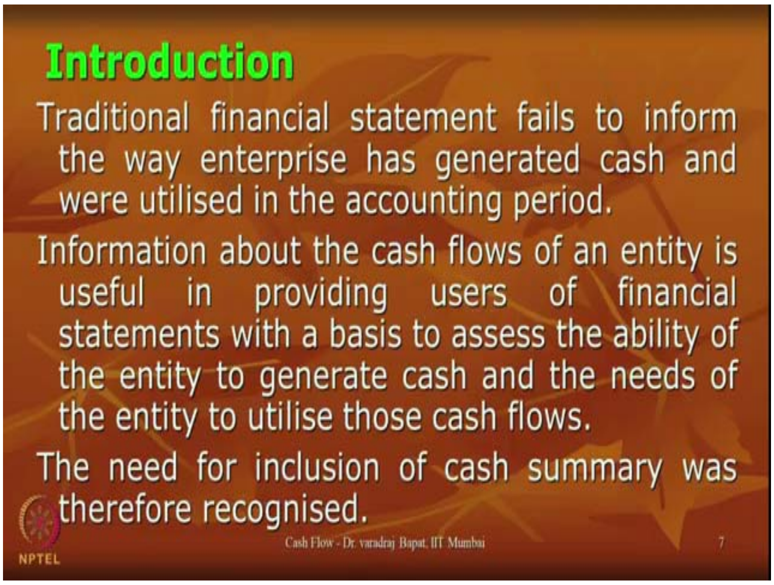

I have just inform you that the traditional financial statements, they fail to give information about generation and utilization of cash, and users of the statement usually want to know what are the ways an enterprise is able to generate the cash and they also want to know how that cash is utilized in a particular period.

So, there is a need to give a summary of movement of cash in a period and there comes the importance of cash flow statement.

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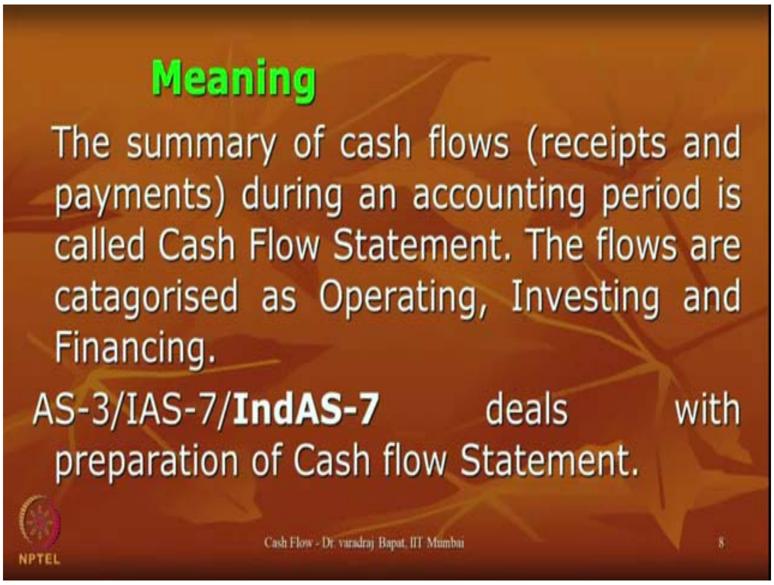

Now, the meaning of cash flow statement is it is a summary of cash flows both receipts as well as payments during an accounting period. Further it categorizes the flows under the three heads that is operating, investing and financing. If you want to read more details, these are the accounting standards on the basis of which cash flows are made. The current one which normally companies are using is called as IndAS-7, it is similar to international accounting standard that is IAS-7 and the old set of standard for this is AS-7; AS-3 which deals with preparation of cash flow statement.

Now, you already know balance sheet you also know P and L account. Now can you think cash flow statement is similar to which of these two statements? Is anyone of you able to think now based on whatever we are discussed now? I think some of you are able to guess it. This is somewhat similar to P and L because P and L is also for a particular accounting period; cash flow statement is also for a particular accounting period unlike a balance sheet. Balance sheet is not for a period, it is prepared at the end of the period, but it is a cumulative statement.

So, if the balance sheet is for 31st March 2020, it will give the assets and liabilities which are purchased or which are acquired in all the earlier years, not just this year; right from the starting of the business till 31st March 2020, if any asset is purchased and not yet sold it will be shown in the balance sheet.

But if you consider a profit and loss account for year ended March 2020, it will only show profits or sales or expenses from first April 19 to 31st March 2020. Are you getting so, it is a period statement; profit and loss is a period statement, similarly cash flow is also a period statement. Now the balance sheet gives you all assets and liabilities. This is not the case with cash flow; cash flow is giving you summary of receipts and summary of expenses. In that sense, some of the items would be similar to profit and loss account, but mind well there are several items in the balance sheet which do not come in P and L, but which are directly reflected in cash flow statement.

Can you think of any such example that a particular item is in balance sheet and because it is in balance sheet, it will come in cash flow without coming in P and L? Just think a bit. Suppose, company purchases machinery and pays cash for it; will it go in cash flow statement? Answer is yes, because company has paid cash for it; will it go in P and L? Answer is no, because it is neither income nor expense. Will it go in balance sheet? Yes because it is a asset so, machinery is a new asset which is purchased. So, it is reflected in balance sheet and because it comes in balance sheet and there is a payment of cash involved, it will also come in cash flow.

So, mind well though I am saying it is somewhat similar to P and L, it is not that it is giving same information as in P and L because there are several items which would be coming from balance sheet to cash flow statement. Any item where cash movement is involved will be shown in the cash flow. We will just have a look at the categorization now because that is very important every flow has to be categorized into three heads as we can see here which are operating, investing and financing.

Now to begin with what do you mean first of all by cash? Because we are saying that it is a cash flow statement. Always keep in mind that when we say cash it refers to cash and cash equivalents. Now, what is cash is cash in hand.

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But of course, cash which you keep in your pocket; in the form of currency notes is not the only cash; it is cash in hands and demand deposits. Now, demand deposits are normally kept with bank. So, in financial statements many times we call it as bank balance so, cash balance plus bank balance both are considered. Bank balance in which type of accounts, if it is in a savings account, yes; if it is in current account, yes; if it is in fixed deposit, no. Because as per our definition, it should be a demand deposit; that means, it should be possible for the company or an enterprise to withdraw it or use it whenever it wants. That is why bank balance is in saving and current accounts will be considered not in the FD account; are you getting? Ok.

Now, other term here used is cash and cash equivalent. Now, what is at cash equivalent? Cash equivalent refers to short term highly liquid investments, we are saying it is cash equivalent. So, it is just like cash; anytime you want you should be able to convert it into cash that is why, those which are ultra short term something which is convertible in less than 48 hours is considered as cash equivalent. There is one more condition attached that it should not be subject to changes in the value. So, can you think of any examples of cash equivalent now? Suppose there is a fixed deposit in bank, will you consider it as a cash equivalent? If the time period is short and there are no conditions attached for its conversion into cash, then you can consider it as a cash equivalent.

What other items? You can sell shares easily in the stock market; can you consider shares balance as the cash equivalent? The answer is no because though you can sell it, it is highly liquid investment, but the second condition is not fulfilled because it is not subject to in significant risk of change. There is a sizeable chances of change in the value so, you know all know that stock prices keep on changing, not only every day, every minute; so, stocks are not considered as cash equivalent. What else can be considered as cash equivalence? There are debt instruments like debentures; will you consider them as cash equivalent? Even then, the answer is no because debenture prices do not change as frequently as share prices, but never the less they can also change that is why debentures are also not considered as cash equivalent.

Any other marketable security like one which is bonds corporate bonds will not be considered; however, if there are government securities or treasury securities which you can sell without a loss in the price, without a loss of or change of price; then, such investments can be considered as cash equivalence. Normally, banks accept deposits which are called as deposits which are for extremely short period like money at call or money at short notice, they are considered as correct example of cash equivalent ok. So, whenever in cash flow statement, hence forth we will use the term cash, it includes balances of cash plus cash equivalence; are you getting me?

Now, let us go ahead. Now what do you understand by cash flow? Now it is a common sense, any cash flows in the form of inflow that is receipt of cash or bank out flows that is payments of cash and cash equivalent, these are all included in cash flow.

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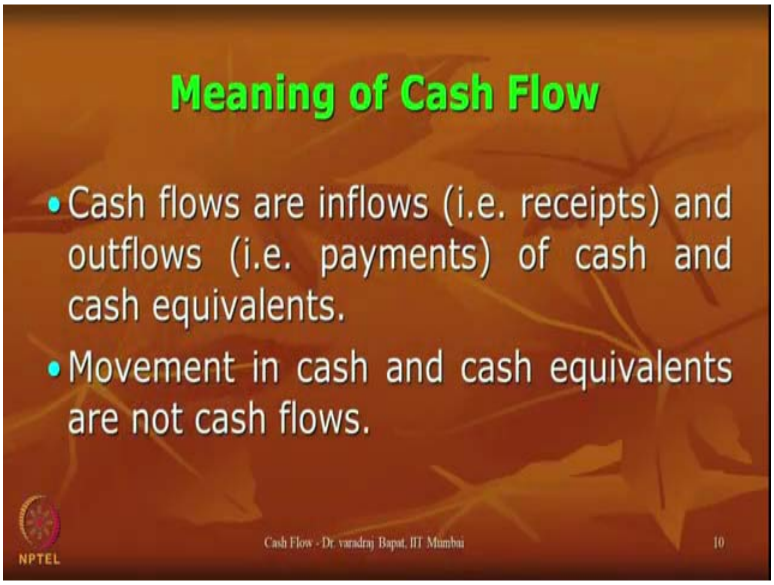

Nevertheless, movement inside the cash and cash equivalent is not considered as cash flow. Now what is a moment in cash and cash equivalent; can you give any example. Suppose, we are having 3 lakh rupees in bank balance and we withdraw it and we received cash from bank, will you consider it as a cash flow? The answer is no, because though you are receiving cash, you are just converting bank balance into cash. So, bank balance is any way an example of cash or if you sell your short term security and converted it into bank balance, there again it is a movement between cash equivalent to cash.

So, we will not consider such movements as a part of cash; got it. So, these are not considered as movement is cash and hence, they are not considered as cash flows. Now, let us go to the types of cash slow.

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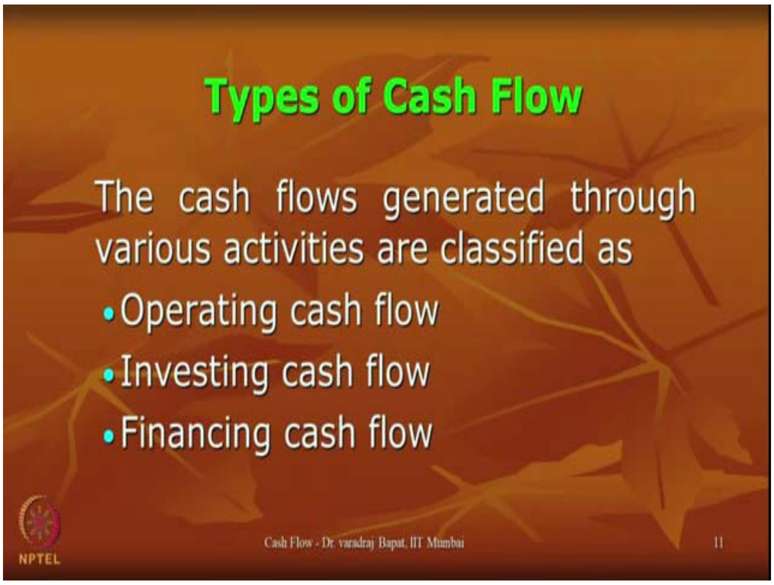

Now the cash flows which are generated through various activities are actually required to be classified, we have already discussed it. There are three heads operating investing and financing. I think these heads are very much self explanatory, but there are some specific meanings attached, but right now at the outset, what do you feel would be considered as an operating cash flow. Just think of what items should be included; are you able to make any judgment?

As the name suggest something which is to do with operations; operation means our day to day business activities. We generate several items of cash coming in and going out. Now they are all considered as operating; this is also a residuary head. So, whatever cannot be considered as investing or financing will also be included in operating and now think of the examples of operating flows, but I would just show it here for your clarity.

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So, now, in the form of figure your all the cash flow activities are divided into operating, investing, financing. Operating means something related to day today activities, I have deliberately not given any example because you can easily think of 30-40 examples related to day to day activities.

Next are investing; now what example you can think of? Obviously, on the screen you can see that very easy example is purchase of land. So, when you purchase land, you pay cash, you receive land. Land is a fixed asset or a property, plant and equipment kind of item; that is why it is an investing activity. Financing, example is loan taken. So, we have obtained loan from bank so, we receive; our bank balance increases and a new liability in the form of bank loan is created. This is an example of financing activity. So, are you getting all the three activities?

Now, let us look at operating activities little more in detail.

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So, these are defined as principal revenue generating activities of the enterprise ok. So, this is the technical term for normal activities or day-to-day activities and any other activity which cannot be defined as of investing and financing will also fall in it. Now, I have given very easy example that obviously, the most important activity for generating cash will be cash received from customers, against either sale of goods or provision of services.

So, suppose you are a taxi operating agency and you provide taxi customers pay you either cash or through credit card or through bank then, you are generating revenue. In which statement will you show the revenue? Obviously, you will show it in P and L account, but you will also show in cash flow statement. Because you are also generating or you are receiving cash in the process. So, this is a very clear cut and very simple example of cash in flow from operating activities.

Now, think of another 5-6 examples. These are very easy as I said you can even list 30 examples. Can you think of some more examples? Suppose you go to some restaurant to have say some lunch so, what will happen? You will have lunch make payment, Now make payment means cash outflow will happen, either in the form of cash or through credit card or by cheque or by some means, means of payment, but in any case since the cash is moving out, we will consider it as a operating cash flow because it is a day-to-day activity it is not an investing or financing activity.

Any other example, lot of expenses I think you might be thinking of like salaries, like a rent paid, they all will fall in the operating activities.

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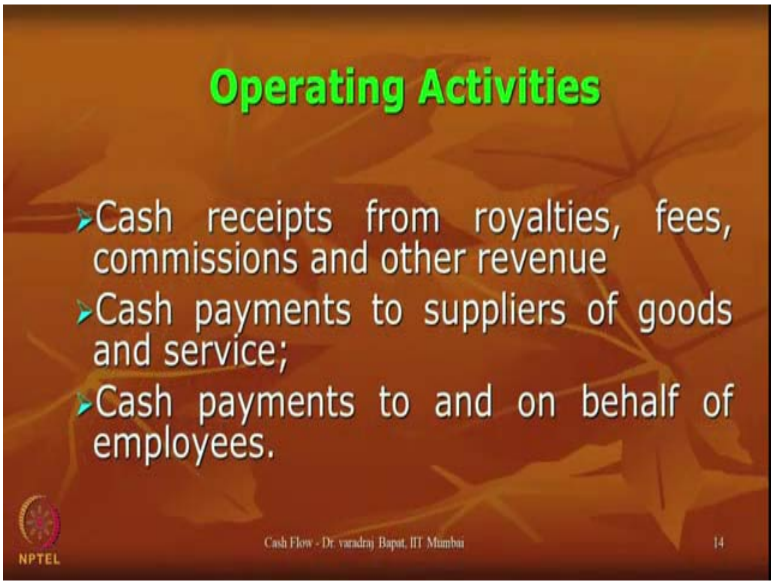

So, these are the examples, I am listing. You can receive some money apart from sales in the form of royalties, fees, commissions, their cash equivalents, cash paid to suppliers or cash which is paid to employees as salaries, allowances, (Refer Time: 18:43) for their expenses all these examples of operating activities. Now, let us go to next one; next is which a head, that is investing activities. Now how will you define investing activities and what are the examples?

Just think of investing activities, now here you are making investment as the name suggest. So, if you are purchasing shares of some entity, it will be an investing activity. If you are putting a deposit in a bank, it will be an investing activity. If you are withdrawing the money from bank deposit and converting it into cash, it is an investing activity. If you are selling your shares or debentures converting into cash, again it is a investing activity. If you are purchasing any fixed asset as say land or building, again it is an investing activity. So, these are variety of examples of investing activity.

Now before going to investing activities, we also would like to understand how are the operating activities reported. Now, there are two methods of reporting of operating activities; one is a direct method, other is a indirect method.

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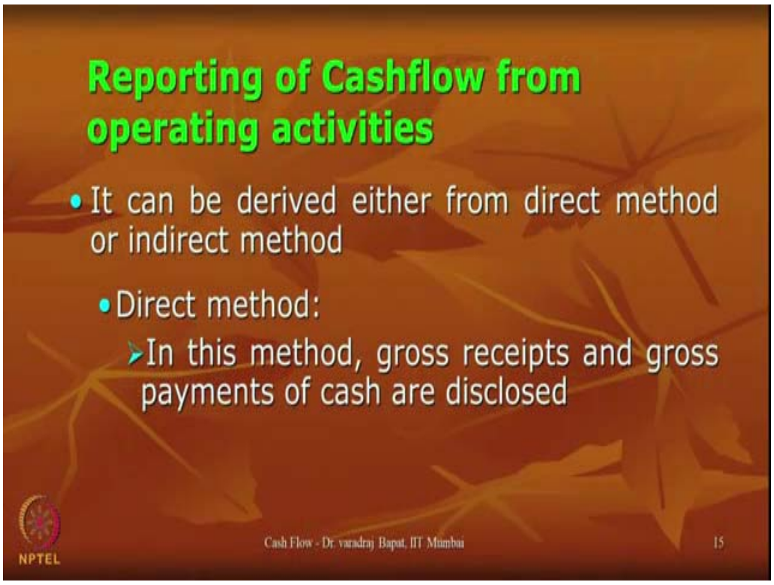

In the direct method, gross sales and gross payments of cash are reported.

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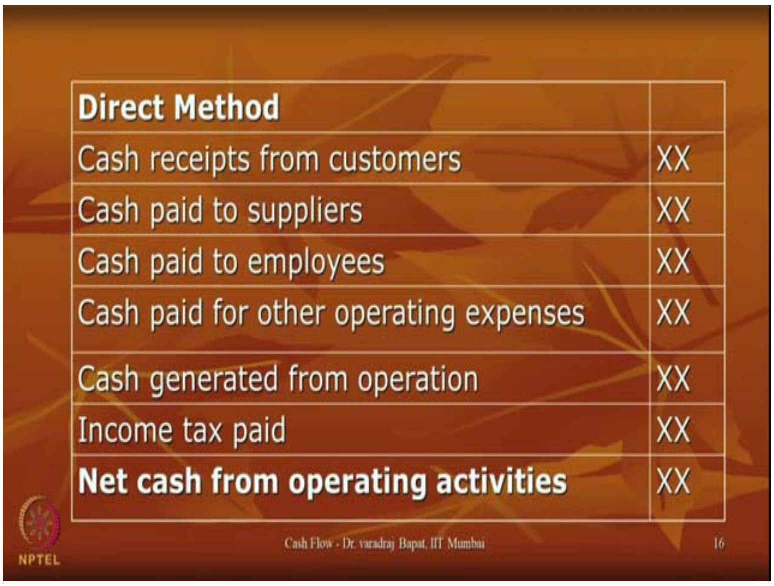

Now, this is a format of direct method, I hope just by observing it will be clear to you that cash received from customers or cash paid to suppliers, to employees etcetera all are shown as a total amount of cash which is either received or paid. The net amount is considered as cash generated from operations before taxes minus income tax paid, you will get the net cash from operating activities. Are you getting; this is a direct method because the total amount of cash received and paid is shown. There is another method which is known as indirect method.

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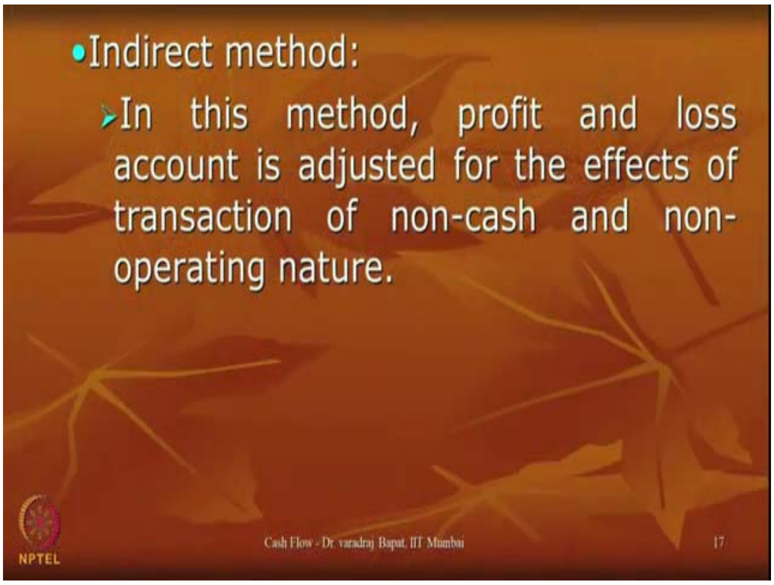

In indirect method, what happens is you start with profit as a starting point from P and L account and then, you make certain adjustments to calculate the cash which is generated from operating activities. In the beginning of the session, we had discussed that cash flow as lot of similarities with P and L.

Actually, this part of cash flow that is operating activities part is very much similar to P and L. So, we assume that whatever is cash generated is in the form of profit; it is not true, but just start with whatever is your profit is assumed to be cash from operating activities and those items which are differing.

So, in P and L account there are some non-cash items they would be adjusted, there would be a few non-operating items they would also be adjusted. That is why from your profit, you work back to calculate the cash generated from operating. Just have a look at the format, I think that would make many things clear to you.

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So, you can start with retained earnings, these are the reserves which are accumulated in the year add the dividend paid because dividend is going out for financing reasons. We will look at it later on, then you also add the income taxes paid. So, you get net profit before tax; then you add depreciation. Why do you add depreciation? Can somebody think of because we have already discussed depreciation in last two sessions. We will add depreciation because if you remember it is a non cash expense, it is debited to P and L or it is charged to P and L, but no cash out flow was involved.

So, we will add depreciation, we will add a few non-operating items like loss on sale of assets or interest paid, provisions for bad debts. So, we will deduct again non-operating items like interest dividend or profit on sale of assets and after making all adjustments related to P and L account. Keep in mind these adjustments are under two heads; one is if you find any item which is non-profit in nature sorry non-cash in nature, we are going to account for it. If there is any item which is non-operating in nature, but it is in P and L. So, we will adjust for it.

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Now, after making both types of adjustments, we get fund from operations. Now, front fund from operations, funds here refers to working capital. So, it is not just cash it includes the current assets and liabilities. So, we will remove the effect of current assets and liabilities. So, from funds from operations we add and reduce all decreases and increases of current assets and liabilities. Here we get cash generated from operations, but before tax. From that we will reduce income tax paid to finally get net cash flow from operating activities.

Are you getting it, I know it is bit complicated because this is a indirect method, this is a reverse method. I will just show the last slide again. So, if you remember once again, I am just making you remember the P and L account. Please have a look at your P and L once again and if you have not understood P and L I think, first you will have to study P and L topic properly before coming to this.

But in P and L account there was a list of incomes list all the expenses giving you net profit. Now here what we are doing is we are starting with net profit, adding all those items which are non-cash or non-operating, they were deducted for calculating the profit for example, depreciation. So, we add depreciation, we add income tax provided, we add loss on sale of asset etcetera; then, we deduct those items which are non-operating, but are added for calculating a profits like profit from sale of asset etcetera. And after making this adjustment you use to get funds from operations.

There we make adjustment for current assets and liabilities. Now, why do we make that adjustment? Because every time you are made profit does not mean you have made cash. Suppose, you are there are credit sales; credit sales will give you profit, but it will not generate any cash for you because the cash is still locked up in debtors, cash may be locked up in stock or your you have not yet received profit, but you have already got money from creditors. All such scenarios need to be adjusted because here our focus is for calculating the cash from operations. Are you getting me?

So, we will stop here. What we have covered today is we have started with cash flow statement, the importance of cash flow statement, the three categories operating, investing and financing. Particularly today, we have discussed operating activities. If it is bit difficult for you to understand, do not worry in next session we are going to revise operating and also look at investing and financing which will make the operating activities once again more clear. Namaste.