Financial Accounting
Prof. Varadraj Bapat
School of Management
Indian Institute of Technology, Bombay

Lecture – 15
Cash Flow Statement 2

Namaste to all of you, we have started with a new statement that is Cash Flow Statement. I hope you all liked it and you are excited about it. So, can you tell: now what is a cash flow statement? It is a statement which lists the cash inflows and outflows. Now naturally with the question comes is why do you need this statement. Now why is it required, what are your two other important statements? The first statement was balance sheet the second statement was P and L account.

Balance sheet gives you what? It gives you the financial position of the enterprise; P and L gives you the income and expenditure. But both these statements are not able to tell you how much is cash generated or spent that is why third important statement was introduced around in 1995 that is known as cash flow statement. It gives you inflows and outflows of cash not only that, it gives you those flows under the three heads what are the three heads? One is operating, next is investing, third is financing.

In our last session we have discussed what is operating, today we will go into investing and financing. Now before that what do you mean by cash that is a first question, because we are talking about cash flow. So, what is a cash? So, cash includes cash plus cash equivalent, particularly in cash you are having cash and bank balances in cash equivalent what do you cover in cash equivalent? You include extremely short term investments which are highly liquid and are not exposed to loss of value because of market forces.

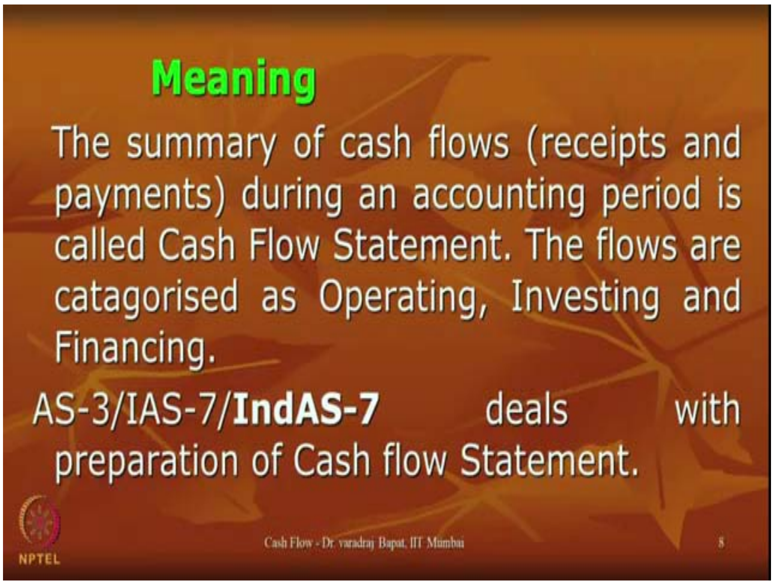
So, something like money at call with banks or money in certain securities, but no change of value is expected there only few restricted securities can be included in cash equivalent. Now any moment of cash is considered as a cash flow, but there is an exception if there is a movement within cash and cash equivalent items do not consider them as cash flow. So, what is such example? So, if you deposit money in bank, you withdraw money from bank this is a change within the cash and cash equivalent; one cash item is coming down other cash item is increasing. So, we will not consider as a cash flow and we will not show it in cash flow statement.

So, here you are got cash and cash equivalent items taken together and there are several other items. If because of any transaction cash and cash equivalent either reduces or increases we will call it as a cash flow and we will be shown in the cash flow statement this much is what we had discuss and how will hope it is clear to you, but you can just glands to the slides once again.

(Refer Slide Time: 03:44)

(Refer Slide Time: 03:47)

(Refer Slide Time: 03:51)

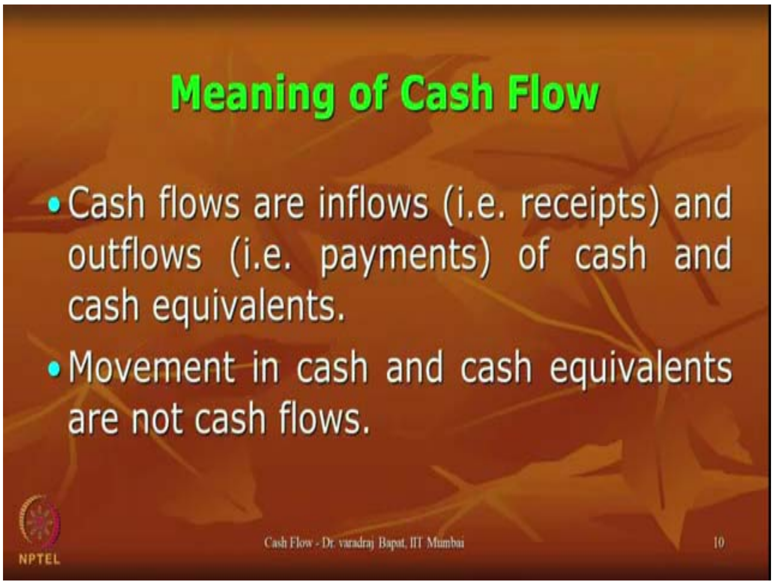


So, this is a index we are slowly going to next items today. IndAS 7 is a new set of standard which we are following for this calculation.

(Refer Slide Time: 03:59)

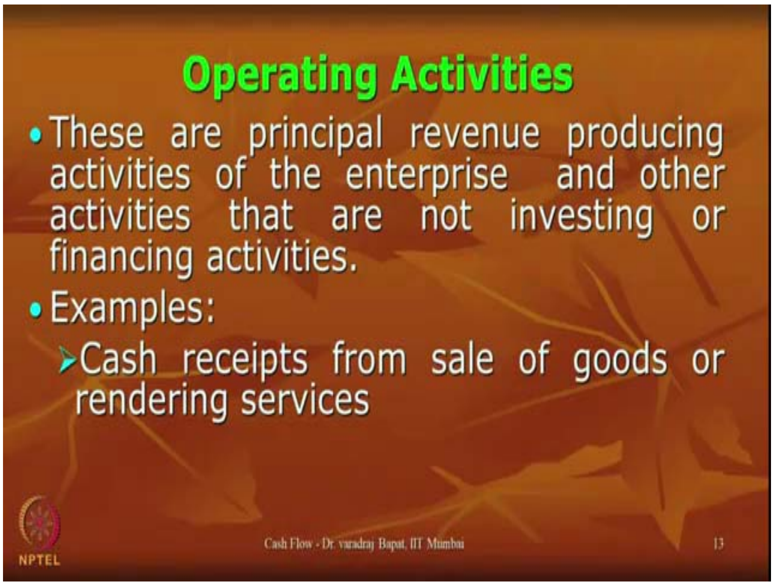
This is the definition of cash and cash equivalent, the meaning of cash, then the types of cash flows.

(Refer Slide Time: 04:04)



Now, particularly we were discussing what is operating cash flow. So, operating as this name suggest means day to day activities or principal revenue generating activities of the enterprise.

(Refer Slide Time: 04:31)



So, any item which is related to either generation of cash or expenditure of cash on day to day business, which is considered as operating activity. Any activity which cannot fall in financing or investing, but there is a cash movement is also included because it is a residuary head known as operating activity. We have seen a few examples in the last session, but today going by the nature of business can you tell what will be the operating activity?

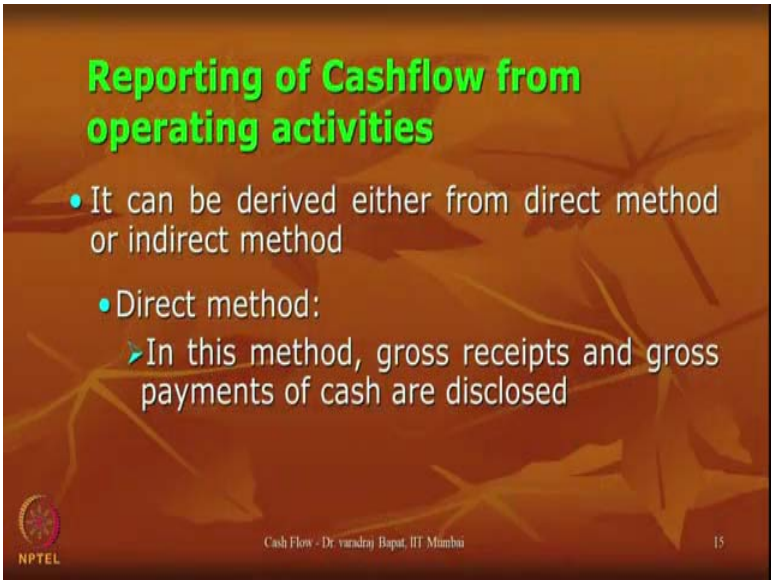
For example suppose you are a web developer, you develop websites for various companies what will be the operating activity for you? What are the incomes for you? Probably are charging some fees to your clients for generating new web content, you may be charging fees for hosting their websites; all these would be incomes for you which will go in P and L, they would also be cash generated for you. Whenever the customer pays you, you are generating cash and that cash is from operating activity. So, it falls in the first example, that is cash received from sale of goods or rendering services.

If you are Tata motors; in the last session we had taken example of Tata motors. For Tata motors what is a principal revenue generating activity, I think most of you know the company they sale cars. So, selling cars, trucks, vehicles is there business. So, money with they generate in cash by sale of car or by sale of a truck will be there principal revenue generating activity. And what are the expenses? I think their common company rent, taxes, salaries, travelling expenses all of them are considered as for running of business. So, there your operating activity related outflows ok.

Suppose you are a web developer company you purchase a car, will it be an operating activity outflow? Answer is no because car is a fixed asset for you, it is not your day to day activity I do not think you will buy car and sell cars everyday who will buy and sell cars regularly? For a car dealer car is a stock item. So, purchase and sale of cars is a day to day activity it will be a operating activity, but for most other enterprises car is a part of fixed asset.

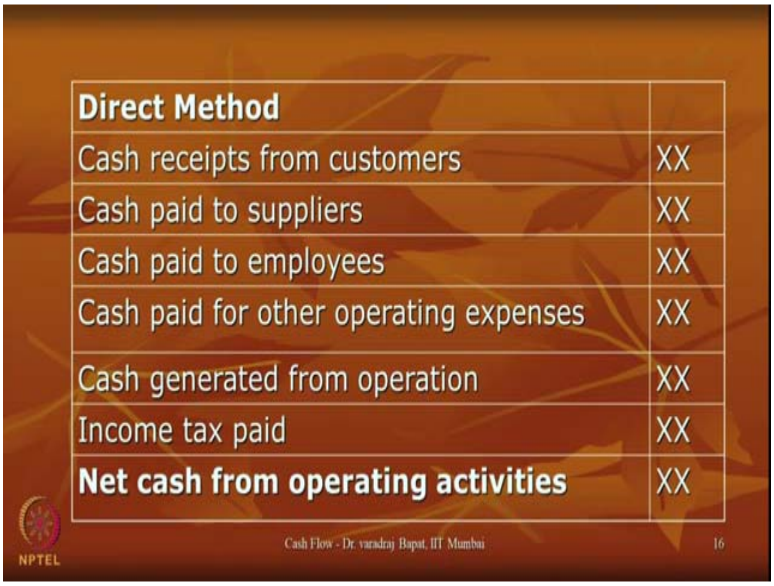
So, for them purchase of car will fall in will go in fixed assets in the balance sheet; in cash flow statement where will it go? It will go in investing activity not in the operating activity; are you getting me? Some more examples are already listed here I think we have seen it in the last session.

(Refer Slide Time: 08:08)



Now, there are two methods of preparing cash flow of which the first method is very simple it is known as direct method.

(Refer Slide Time: 08:13)



So, please have a look at the format I think it does not need any much of explanation it is very similar to P and L actual. In P and L you start with sales reduce all the expenses you get profit. Same way only exception is there we show actual payments plus outstanding expenses here you are only concentrating on actual receipts and payments.

So, receipts from customers plus cash sales, that is your cash receipt minus payments to employees, payments of rent, payments of payments to creditors not a purchases keep in mind P and L account we show purchases whether you pay or not it is considered as a expense, here only that much amount which you have paid to creditors. In case of cash purchase the amount will be same, but for credit purchase your purchasing now paying later whenever you are paying it will go in cash flow statement ok. So, but this is relatively simple only one thing you have to keep in mind is almost like a P and L, but it should be on cash basis are you getting me. So, you are listing all cash receipts minus all cash payments from operating activities, they would be net cash from operating activities.

Now, the second method is slightly complex because here we are going from P and L to calculating cash from operating activities. So, in P and L account we get profit or loss for the period. We start from back or we start from transfer to reserve sometimes then we add back of few items to begin with we assume that profit is very close to cash from operations only those items which require adjustment. Suppose there are 40 items in P and L all of them will not need adjustment, few of them which are of two types they would need adjustments, only those two types of items we will either add or reduced. So, what are these two types of items? One is if it is non-cash I will just show you the format.

(Refer Slide Time: 10:34)

So, we are starting with retained earnings plus dividend plus taxes, that is net profit before tax then we add noncash items; best example of it is depreciation because we are already discuss depreciation earlier, that it is not a cash expense it is charged to P and L, but does not involve cash so, be added back. Similarly if there are any non operating items. So, what are the non operating items? Keep in mind most of the items in P and L are operating, but a few items like sale of machinery and there is some loss on sale of that machinery that loss, but we will be shown in P and L.

But, we do not want to have it here in cash flow that is why we add it back. So, add loss on sale of some something like a machinery. Similarly, if there is a profit on sale of land that is already shown in P and L so, we reduce it from there because its not operating item, we make a adjustment for it and after adjusting these items we get funds from operations.

(Refer Slide Time: 11:47)

After this also there is a third adjustment that is related to your current assets and current liabilities. So, what happens is, from your current assets if there is a increasing current asset, it leads to less cash in the hands of company. So, suppose there are receivables. So, you have sent sold a goods, but you do not get cash your data. So, receivables are increasing your cash is falling.

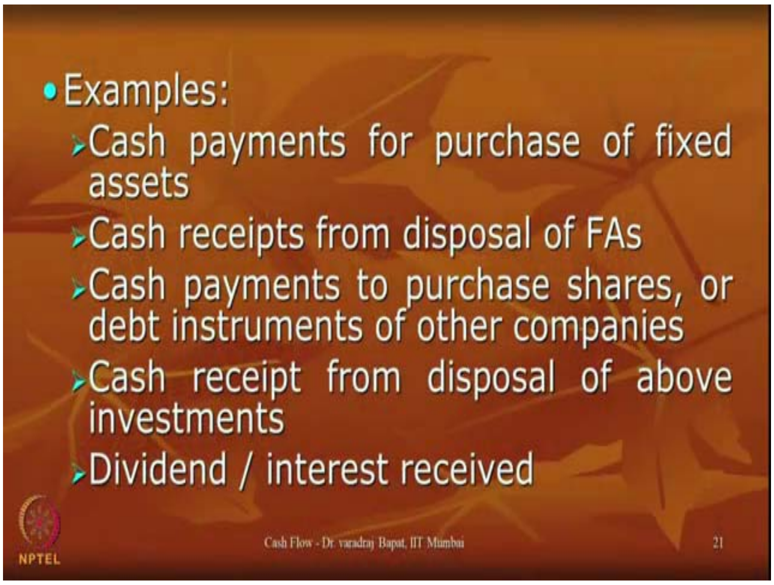
So, any increasing current asset there is a fall in cash keep in mind there is a competition between current assets and cash; cash is also one of the current asset. So, other than cash if any other current asset is increasing, it leads to decrease in cash. You can have a look here there is a less increase of current asset similarly if current asset decreases like you have credit you have debtors, debtors pay more cash to you their balance will go down and you have more cash that is my add decrease in current assets.

So, from the balance sheet we will get balances of current assets and liabilities, we would have a look at increase and decrease make the adjustments in the funds from operations that will give you cash generated from operations are you getting me? So, fund is a amount of profit generated, but it is not cash. So, we are making adjustment and calculating cash generated from operation, we will have to deduct the income taxes which are paid that gives you cash flow from operating activities is it clear? This much we are discuss last time, but since it is little more complex we have just revised it again we are now going to next two heads, the next head is investing activities.

(Refer Slide Time: 13:56)

These also bit of we have discuss last time so, all those activities which are related to long term assets like fixed assets or investments, they would be included here in investment investing activities. So, what are the examples? Either purchase or sale of fixed asset; so, purchase of land sale of land, purchase of machinery, sale of machinery these are all investing activities or related to investments like keeping FD or withdrawing FD with bank, purchasing some shares or selling some shares all this is included as investing activities.

(Refer Slide Time: 14:42)

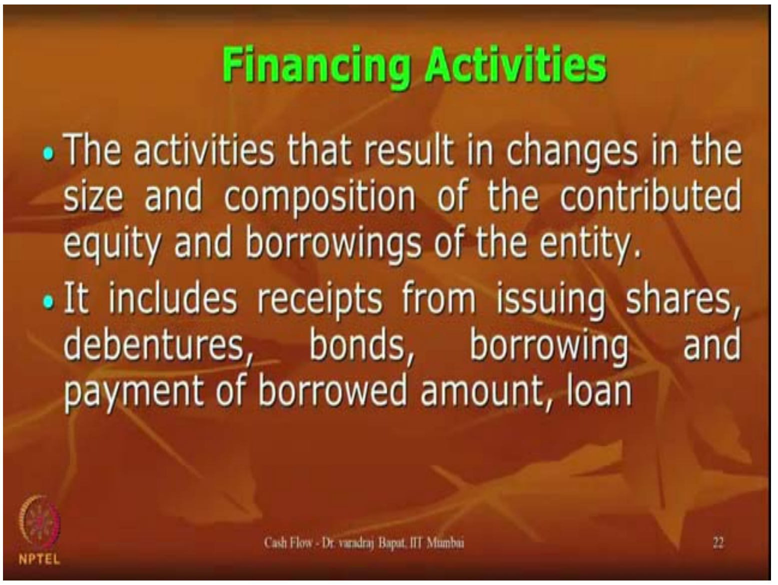


So, these are few of the examples just have a look at them. If you put FD in bank you will receive interest there on, that interest is also and investing related flow. If you purchase shares you will received dividend there on, that dividend is received because of your investment that is why it is considered as a investing activity that is also an example of investing activity are you getting?

So, in operating activities there were two methods what were the two methods? Direct and indirect; luckily there are no two methods in investing activity you have to directly show whatever is you have received or paid that is why calculation of investing activities very simple there is nothing to be afraid, whatever is a amount which is paid either on fixed assets or investments or received because of them that will be directly show. Keep in mind we are not talking of profit or loss on sale of machinery that is for P and L. In fact, now we are only concerned with the total amount which is either received or paid for fixed assets getting it.

Now, the third type of activity is known as financing activity. Now here in the first session if you remember we had seen that business needs resources, those resources are assets now these assets are financed by somebody. So, somebody makes you payment you get some money from that money you have purchased the assets. Now from where you have raised the money or from where you have generated those finances they are categorized as financing activities.

(Refer Slide Time: 16:45)



There are two important types in it one is known as equity, the other is known as borrowings. Do you remember, when we discuss balance sheet we had discussed is I would request you to go back and have a look at balance sheet format. So, what does it fall what does falls under equity? These are the owners funds these are the moneys of the shareholders like share capital or preference share capital that will be shown and what are the borrowings? Borrowings are various types of loans taken by you. So, either loan taken or loan prepaid or interest paid on that loan they are all falling under financing activities.

So, here some examples are given like issue of shares or debentures borrowings and so, on what do you mean by debenture do you remember? So, debenture is also like a loan company obtains a loan and gives a certificate to the lender in the form of debenture certificate, that is called as a debenture. But, it is just like a loan for the company so, that is also a financing activity.

(Refer Slide Time: 18:01)

So, here there are some specific examples when you issue shares exactly reverse of it is called as buyback of shares; that means, company takes back the shares from shareholder and gives them money that is called as buyback of shares so, that also a financing. Same way issue or redemption of preference shares or debentures; in issue what happens? Company receives money gives preference shares. Buyback or redemption is exactly opposite company takes back shares give them cash both the cases the cash is involved and it is related to financing of the business. So, it will fall in the financing category of cash flows are you getting?

Now, whenever you raise funds, you have to compensate your investors in the form of interest or dividend. If you take loan you will pay interest that is also financing activity if you raise money by way of shares you will pay them dividend that is also a financing activity; are you getting all the examples? Now, let us consider some specific items in the cash flow of which the first one is interest. We have just discussed it already, but this will be reinforcing in your mind interest can be received or paid.

(Refer Slide Time: 19:20)

Now, to begin with how do you account for interest received? We have already discussed this that you receive interest mainly because you are made investment. So, if you are made investment in bank like FD or if you are maid investment in debenture of some other company, you will receive interest from them that will be categorized as investing flow, but there are some exceptions to it which have noted please keep in keep them in mind.

Suppose the investment is in cash equivalent for example, investment is in ultra short term deposit which you have categorized as cash equivalent, then it is not an investment. As far as cash flow is concerned it is not an investment that is why interest received on cash equivalent type of investment will be considered not as an investing activity, we will categorize is an operating activity because it is a day to day item similarly sometimes we receive interest from trade advances getting me?

So, suppose we have put some money as an advance to our suppliers and they give us interest on that amount it is rare it does not happen every now and then, but suppose it is there we have received some interest from it or suppose there is a bill receivable and on bill receivable we have received interest then it is not related to any investment it is not a long term activity. Because typically it is for one month two months three months four months like less than one year, that is why those investments and interest there on would be categorized as operating activities.

And the third example which is for specific type of undertakings or company is known as finance enterprises. What are the examples of finance enterprises? For example, of bank a non banking finance companies for them finance is there business. So, giving loan is their business. So, they are bound to receive interest from their customers, that is there day to day business activity or principal revenue generating activity. So, we will categorize it as operating flows for all finance related companies are you getting. So, this is about interest received.

Now, about interest paid. Now interest paid as you all know by default we will treated as a financing activity, but there are a few exceptions.

(Refer Slide Time: 22:26)

Suppose the loan is obtained as a working capital loan, I hope you know what is working capital. Working capital means current assets minus current liabilities this is a capital which is used for day to day activities or if you remember our session 1 and 2 we had seen a business cycle. Now whatever is money blocked up in business cycle you can get some loan from bank for specifically for working capital.

Now, if you pay interest on a working capital loan, it should be categorized as an operating flow not as a financing flow. And the third example or a second exception you can say is for a finance enterprise. Now, naturally for a finance enterprise paying of interest is a part of their day to day activity they receive interest they pay interest so, far them interest paid is categorized as a operating flow are you getting. So, this was about interest; now based on these can you imagine what will happen for dividend? Because dividend also you get both the categories like dividend interest and dividend received and dividend paid.

Now, if it is dividend paid what will happen? Whom do you pay dividend? We raise money by way of shares. So, share holders pay us as a company their money to compensate them we give them part of share of our profit that is known as dividend. So, it should fall in which category? Is it operating is it investing or is it financing? I think most of you are guessing it correct this is related to raising of funds.

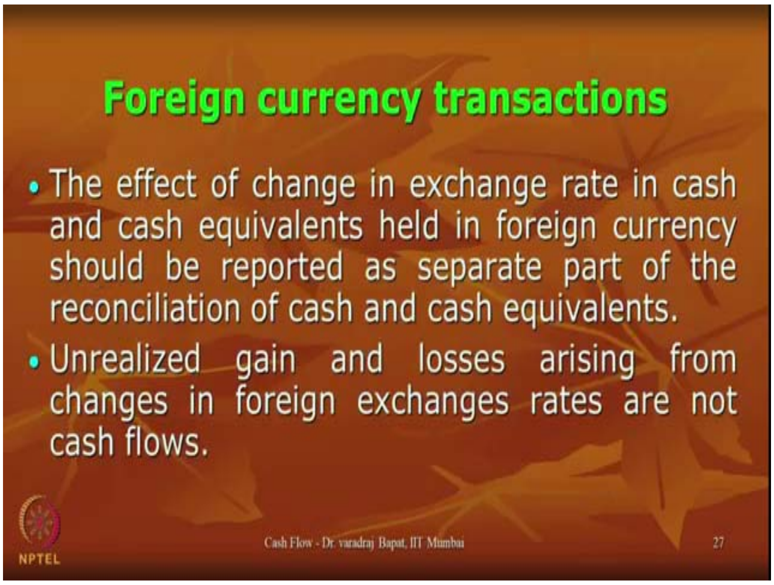
So, it is a financing activity, we have raised funds by way of shares we give dividend to shareholders. So, it will be considered as a financing outflow are there any exceptions like for interest? Now this is a peculiar item there are no exceptions even if it is a finance company, even if it is a operating item or whatever you will never consider it has operating or investing dividend paid is always considered as a financing item.

What about dividend received? Where will dividend received go? Dividend received is very similar to interest received actually by default it will be considered as an investing flow.

(Refer Slide Time: 25:22)

You will just go to that slide. So, dividend received what happens is for a non financial enterprises, we will always categorize it as a investing flow because we have made investment in shares we get dividend. But for a finance company or for a bank we will categorize it as a operating flow because for them it is a day to day activity and dividend paid we have already discuss is always categories as a financing.

(Refer Slide Time: 25:52)



So, you are getting me. So, we have discuss now today few peculiar items, first we discuss the investing operating, then investing, financing and two peculiar item that is interest and dividend. In the next session we will take a few more items and then we will start looking at the problems, Namaste.