Decision making using financial accounting
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Lecture - 20
Cash Flow Statements - 1

We talked about two basic financial statement so far that is the P & L - the profit or loss statement, receipt and expenditure statement, or income and expenditure statement etcetera, whatever name you call it, and then we talked about the balance sheet. These two financial statements as such are mandatory for every organization that is basically registered out there for them to prepare at least once every year at the end of financial year.

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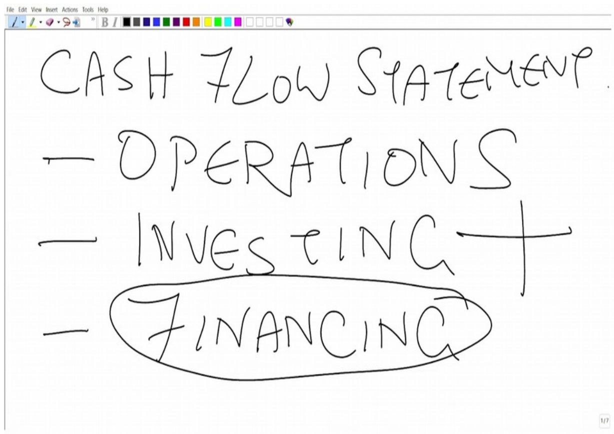

So, now we are going to talk about the third financial statement what I normally call it as or what we call it as basically the cash flow statement. This cash flow statement or this statement, the third statement what we are talking about is also mandatory, but only for companies that are listed, the companies that are listed it is mandatory. Whereas the other two statements of mandatory for every company that is registered. The third statement because mandatory only for those companies basically which are listed; listed in the sense, list as one of the exchanges in India.

So, what we normally do is, normally all these three statements are looked at in tandem when we are looking at analysis of any company out there. Now, why do you need a cash flow statement? Why do I sort of I am very happy with the P & L statement itself, why do I need to prepare a cash flow statement? Primary reason, your P & L statement is purely on what we call it as accrual basis, it does not give you the exact amount, the profit might be there or the loss might be there, it will never match with the amount of money the cash what you have either in your bank or your cash whatever it cash box or whatever it is. It will be completely different.

Imagine a situation, where I have made all my purchase all my sales on credit, and I have actually not paid. Your profit will be humongous, but you would be what you call it as it say cashed out as far as the entity is concerned. You have made all your purchases on credit. I am just giving you simple mundane example. You made all your purchases on credit and none of the guys you are paying up, whole process what happens you have a lot of cash left and does not mean that you got to be feeling very happy about it.

So, what happens a company makes a lot of profit, we will say oh made a profit, I should be happy, well, you got to look at the other statements also is the profit translating to cash. Now, I got a lot of cash. Now, I need to know a simple you could have borrowed money from a bank and there could be lot of cash lying in your cash box out there, and that need not be basically from your operations also.

So, in the process, what we try and do is, we try to look at what the third basic financial statement what we call it as a cash flow statement out there. In a cash flow statement, we look at couple of aspects. We look at dissecting this cash flow statement. I use the word dissecting because we are splitting that is the may be that might be a better word to use for you guys. So, what we try and do is, we split the entire cash flow statement into three basic parts. Now, I want to see what is the kind of cash that comes in basically from my operations.

Now, I want to see the other cash, cash that comes in from my operations when I say that is a slightly wrong word, cash flow from the operations. Why, because cash only need not come in from operations, it can also go out, you pay your salaries, you make your purchases etcetera. So, we will say cash flow from operations. It means both in flow as well as outflow out there.

Now, I move to the second statement, second part of it. What we look at, we will say cash flow from what we call it as investing activities. Now, the third basic aspect, I will explain each of this, we call it as financing activities. So, what we look at is, we look at the third basic aspect we said financing activity. Now, let me give you some examples of all these. Now, I say I pay dividends to my shareholders, there is a cash out flow when you pay dividend, agreed or not? Agreed.

Student: Yes sir.

Now, when there is a cash outflow because of a dividend activity, what is that, what does that pertain to, does it pertain to operation my investing on my financing? Why do you pay dividends, why do you why do you pay dividends, because somebody has put in money in your company. What have they done to your company? They have financed your company, please note, investing is when you invest, please always think from your company, your point of view. Everybody said investing and operations, we will conveniently left our financing right.

Student: Right.

Basically what is happening, somebody is financing that is a source of fund, the capital that comes in is a source of fund for you. Am I with you on this? When capital is a source of fund, when I give them return, what is a cash outflow, cash outflow because of somebody has financed, I am repaying that fellow. I am paying not repaying, I am paying some dividend out there, even if I repaid is the same. So, what is happening, cash flow occurring because of what we typically call it as in this particular case the financing activity. Agreed? I borrow money from the bank.

So, what happens? So, think through it slightly that is all when I take money from a bank, what is it in a source of fund it is a source of fund for me, it somebody is financing maybe a debt, maybe debenture. So, it is a cash inflow that is money coming into me, because I am borrowing money from the bank, money coming to the company. When money is coming to the company money is coming in because of what activity financing activity. So, what is happening, there is a cash inflow occurring because of a financing activity. With you on this?

Student: Yes sir

So, similarly let us look at I receive dividends.

Student: Investing.

Student: Investments.

Beautiful ok. Now, what happens because you have invested money somewhere that is where you are receiving dividends, please note dividends paid, dividends received, there is a subtle difference there. So, in this whole process, what am I trying to do, I am looking at I have pay invested money, I am getting some return. So, what is happening, I am getting money because of my investing activity out here. So, in the whole process, what we are trying to do, every aspect of cash flow that happens, we are trying to trace it back to one of these three aspects. I pay sitting these for my board of directors.

Student: Operations.

Student: Operations.

Purely your operations, because for the core activity. Normally, it is basically for the core activity out there. So, you are looking at it as there is a cash outflow from for an operating activity. I pay wages, I pay salaries, etcetera, all cash outflow because of an operating activity out there.

So, what we are trying to do is we are trying to classify all the money that is either going out of the company or coming into the company into these three buckets, nothing, no rocket science, it is very, very simple, any money. But only thing is you got to determine what is the money that is going out of the company, and what is the money that is coming into the company. The sheet of paper what he has given of there that is just an example which we will try and see if we can solve it.

Just do not read the entire thing just read the first aspect out here, give me a copy, thank you. Just read the first aspect out there. Just the first line sales 30650 that is all you can keep the paper down, no worry, you can leave just leave the paper down, 30650 is the sale. So, what is a cash inflow or a cash outflow, what happens?

Student: Inflow.

Student: 30,000.

Are you sure, sales is an outflow?

Student: No.

Cash.

Student: Inflow.

Well, I am talking about cash ok, cash inflow how many of you are sure that it is an inflow, entire 30650?

Student: No.

How do you know this it is all cash sales, where is it mentioned it is cash sales?

Student: Not mentioned it is there.

Maybe all are credit sales, maybe all are still due. Am I with you? So, what you trying to do is when we look at a cash flow statement, when we are sort of arriving at a cash flow statement we take the P & L and the balance sheet. If it is due, then what should it be, it should be lying on the debtors side of the balance sheet obviously.

Now, in this particular case, now pick up that paper. You see there is a sale and just read the debtors column in what is called as a balance sheet out there. In the same sheet, it is all in the same side of the sheet, just read the debtors column in the balance sheet out there.

Student: 1700.

1700 that is for the current year

Student: Yeah.

Then there is something for the previous year.

Student: 2400.

So, how do we do it? What is the actual? Now, tell me what is the cash you would have received?

Student: (Refer Time: 10:02).

Second aspect, now hold it for a minute, hold it for a minute. The second aspect out here, now second aspect out here unlike in a P & L, let me again restress, unlike in a P & L, we do not worry about to which year this particular cash inflow or outflow pertains to. We are not worried about it. You might be receiving some money for a sale which occurs 10 years back, will you record it in the P & L this year? No, you will never because the sale of taken place 10 years back you have recorded. Whereas, in a cash flow what are you worried about, you are not worried about to which year, what purpose, you are worried about money coming into your cash box and getting out of your cash box that is all.

So, in this particular case, what do you see, you see that there are some amount due at the end of last year. There is a particular quantity of sales that has taken place this year. There is some amount due at the end of this year. Normally, the amount due at the end of this year, for example, in this let us take this example itself, what is the amount due at the end of this year?

Student: 70.

Debtors current year.

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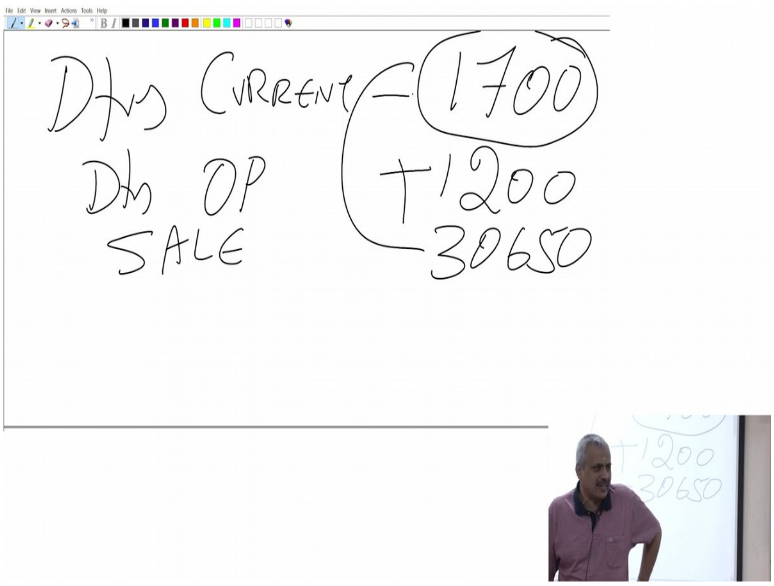

Student: 1700.

1700.

Student: Yeah.

Ok beautiful. Now, there is, what is the old debtors out there, how much was it dues last year?

Student: 1200.

1200. Now, supposing you had received this 1200 during that particular year perfect, even that is a cash inflow will that get recorded anywhere in the P & L?

Student: No.

Supposing, you had not received that money this year last year, then what would happen, would it just get out of your balance sheet? What will happen?

Student: Still show.

It will still show. So, this 1700 what is there as far as the current year is concerned, what you have talked about.

Student: Plus.

Could possible include if you have not received or that could be pertaining to the entire current sale of this particular year also. If you have not received it obviously, because please note when you talk about a balance sheet it is what is due as of today. Somebody can argue, sir I have written it off, fine, not a problem. Then this 1700, they have, is there anywhere is it mentioned that old dues were written off, if you old dues were written off, then fine we will take care of it. There is nowhere it is mentioned the old dues were written off.

So, as of now what happens if the you do not receive the money, in a balance sheet what does it talk about, it talks about what is due at that point of time when you basically draw up your balance sheet. If you have received it, it is not due. If you have not received, it is still due as of today, last year also it was due, this year also it can be due, next year also it could be due, if you have not received it. It can keep getting carried forward. Now, from the balance sheet will I make out whether it is what is called as it is this year's due or last year's due etcetera. Well, this is a consolidated part, you may not make out.

If you look at the annual report, you will be make out to a certain extent that is they will always divide it into due more than 6 months, due less than 6 months. If you go into the details, then you can sort of get, if we go and look the schedule and other things. So, let us not worry about that aspect as of now. So, what happens if you have received it, you would have got it; if you have not received, it would actually be there.

So, what is a total cash you would have received from customers this year? What is the sale? Let us take the sale also. Let us take the sale figures. Let get sale figure. What is your sale man minus 500 agreed? Simple, ideally let us look at it like a plain slate, this is the sale that has happened 30650, the sale that has happened out there. I must have received this money. 30650 is the sale that has taken place this year.

Ideally you are eligible to get the entire money on sale ideally plus you need to get the money what has due last year also, maybe you I mean what is a due what is the total money you are eligible to get your total money you are eligible to get is the sale that has happened this year plus the money that is already due as far as the balance sheet is concerned, so that we will make it 31850. Out of 31850 still about 1700 is still due. So, how much money you would have ideally got 31750 minus whatever is that 700 is basically the money that you have received from operations out there.

We are not worried about this 1200 pertains to last years are, should we have take it cash flow, what are you worried about, money coming in, money going out. What are we worried about, salary that is every month on 31st, we will just see you look at your account and say what is the money that is coming in whether it is arrears or not arrears, we do not care about it right.

If the money is good, then we are happy. So, something cash inflow, cash outflow that is all. And what happens in this particular period to which year it pertains, we do not worry between a set date that is also cash flow statement is also for a set period out there, either for a year, for a month for, unlike a balance sheet, unlike a balance sheet, unlike a balance sheet, like a similar to P & L, it is for a set time period. It is for a set time period out there.

Yes, Mallukrishna, 1700 is it the debtors only for this year is it anywhere mentioned. 1700 is due as on the day, that means, it could as on this day it could include from this years it is due. So, from which year it is due, no, no idea, that can be further split. For example, part of it belongs to this year, part of it last year, part of it year before last etcetera, etcetera. But as of today what is the due 1700 is due. As of today how much are eligible to get, the entire sale value plus basically now what happens in this particular case, what we see out here on this case what are you eligible to get, what I am eligible to get is the sale of this year, I am eligible to get, I am liable to get it plus whatever was due in the last year, I am eligible to get it. Am I with you on this?

So, what I have actually got, these are the total money I am eligible to get less what is still due is what ideally got received in the form of cash out there, that is all what I do it. So, what happens this that is 30650 plus your 1700 minus your 1200 or whatever that is the, no sorry, it is the other way round. It is just the of it is other way round out there of right there that is plus your 1200 is what you are eligible to get minus 1700 which you have not received basically that is the total money you have actually received because of what activity.

Student: Sales.

Student: Operations.

What activity?

Student: Operations.

Operations. Cash flow we will take only these three terms, nothing else, because of an operating activity. Cash inflow occurring because of an operating activity. Am I with you on this? I am going to give you a minute, can you calculate what is cash outflow as far as cost of goods sold concerned, it is a only cost of goods sold is concerned COGS, the next item on the statement out there only on cost of goods sold.

What is the cash outflow cash cost of goods sold is cash outflow right because your purchases and salaries and everything. So, what is the amount of cash outflow that would have happened, can you just calculate and tell me? It says 26000 you just calculate.

Student: (Refer Time: 17:30).

COGS ok. For a minute here, 1 second guys. COGS, COGS is nothing but cost of goods sold. Cost of goods sold is the total cost your manufacturing etcetera till the point of sale barring your administration that is all your direct manufacturing cost or indirect manufacturing cost everything put together that is the cost of the goods which is ready for sale.

Now, for because it is very clear, what do you what is operation what is see in that in that aspect of there, whatever related to financing is financing right that is what I have been talking about. So, for example, dividend payable or paid - financing, dividend received - investing. So, it is very simple out there.

Student: Financing.

You have borrowed money from a bank to purchase a machinery. So, what have they done?

Student: (Refer Time: 18:16).

No, that, but still what have they done, they financed your asset, whether you where to which asset pertains to it is a, it is not a issue. They have financed your business. For example, when you can raise capital in two ways equity, debt. When I borrow money from a bank to setup my factory, what are they doing, they are financing my business out there. But what happens when we did a sale, what did we do, sale means there is a basically you have sold goods, you are liable to get the money, and the guys from which you are not, you are not got the money they are all in the form of debtors out there.

What does COGS include, cost of goods sold, cost of goods sold basically is all the purchases of your materials that you have basically materials you have purchased plus all other expenditure that relates to your manufacturing till the point of sale out there. So, it includes, obviously, your purchases whatever your made of your raw materials, your wages and salaries, basically what you pay your power fuel lighting and other expenditure related to your manufacturing. Let us keep it for manufacturing as of now

Student: Yeah.

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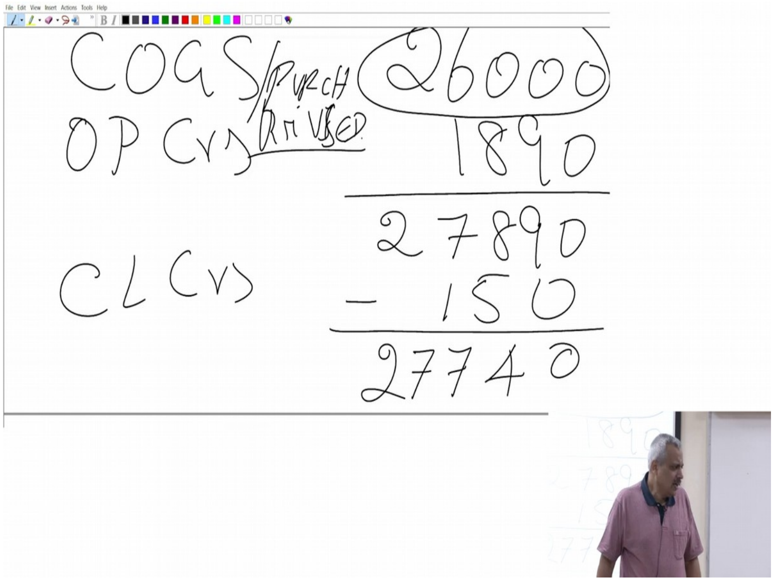

Now, in this particular case, it says my cost of goods sold is basically 26000 right. Cost of goods sold is material utilized. Please understand this is from the P & L. When it is from the P & L, it says it is the material that is utilized for the quantum of sale that has basically happened or for production this particular year during that time period out there. You know, that means, material utilized you might have bought material you might have sold material whatever it is. You even you have bought material, you could either buy in cash or buy on credit out there.

Now, imagine I have made all the purchases on credit, or imagine I have made all the purchases on cash, and there is no stock out there, no opening stock, no closing inventory, no creditors, opening creditors, no closing creditors out there. Then what happens, what is your cash outflow, your cash outflow will be exactly equal to a 26000 rupees what it is there.

Let us take one aspect at a time. Now, that is the amount that you are you are liable to pay, but God damn it there is always creditors sitting out there. That is the fellows from whom you have been buying goods on credit. Last year if you look at there were some amount of creditors out there, there is some opening creditors out there you are opening creditors or to the extent of about 1890. You got to pay those fellows also this year, that is your total liable payment that is I will say opening creditors is 1890. Now, this is the amount you are liable to pay. Am I with you or not?

Student: Yes.

You are liable to pay. Am I with you or not as of now? Yes.

Student: Yes.

But still there is some closing creditors also of about 150 dollars that is 150 rupees that is basically due out there, that is you have not paid for those fellows. So, basically there is a closing creditors of about 150, that means, ideally what you should have paid will basically be what you call it as am I right with the total?

Student: Yes sir.

Now, this is ideally this is the amount what you should have paid. So, what are we trying to do, this is ideally the money that you should have paid out there. Am I with you on this? So far so clear, any doubts on this? 1890 can include that 150, may not include that 150, I do not know maybe. What you are saying Mr. Srinivasan is right, because it might include this 1890 is 150 is this, sorry this is opening or this is closing this 150 out here closing might not be pertaining to this year sale at all, might be pertaining to your opening creditors its self last year creditors, somebody has not paid still maybe there is so much. It may not even pertain to this year sale this year sale imagine is all cash sale, that 150 which is due might be a legacy which you are carrying forward in one from 1890 etcetera possible.

Now, how sure are you is that that entire 26000 rupees worth of cost of goods that you have sold is bought only this year?

Student: (Refer Time: 22:52).

(Refer Time: 22:53) Now, might not be bought this year. You might have lie this end 26000 rupees worth of goods might be a bill lying in inventory which you would have bought last year, and you would have used it possible or not?

Student: Yes sir.

If that is possible, then is there a cash outflow that is occurring because of the purchase this year. There is no cash outflow that is occurring because of the purchase this year. Am I with you or not?

Student: Yes.

So, out of this 26000, how much of the goods I have used it from what was there in the last year that you will see what is the opening inventory out there, 27740.

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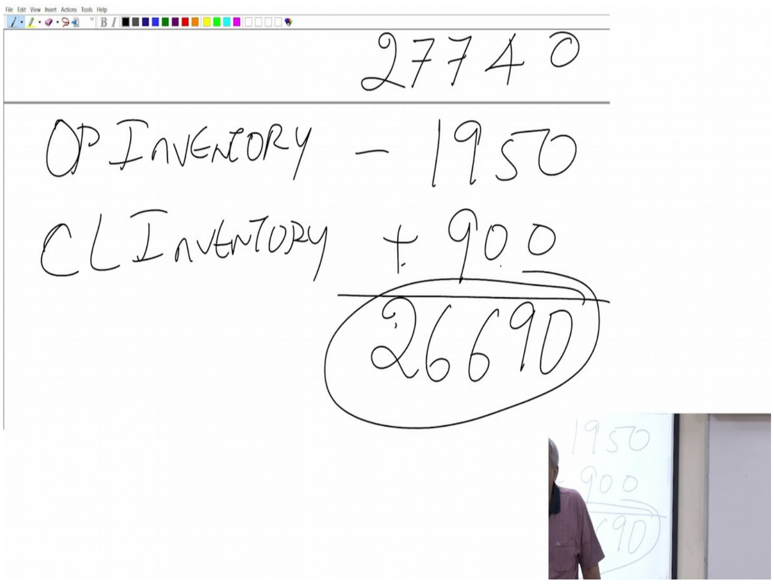

What is the opening inventory?

Student: 1950.

Student: 1950.

So, this 27740 is what you are should have ideally paid, but out of the 27740, 1950 worth of inventory we have used from the last year that was there in the godown already. You have not made any new purchase so should. So, ideally what I should do, I will be able I should basically be what is called as reducing that amount out here. Am I with you? So far so good? Some confusion? Yes, sure sir, 100 percent fine.

Again I repeat for the benefit. What did we look at in this particular case so far? We said is of COGS as of now keep it as what is called as purchases, simple keep it as purchases that will be a little more simpler for you purchases of raw material. You have purchased that is are in in or purchases of raw materials or whatever raw materials utilised used, you can actually keep it that way whatever in the P & L. Raw material utilises 26000 and the P & L. If you want, you mark it that way.

26000 dollars is the kind of raw material that is utilised this particular year as far as P & L is concerned. Now, ideally is the cash outflow equal to 26000, no, because there is some money still due this year, there is someone there was some money which was also due last year. So, we found out what was the money that you are liable to pay as of that particular year as 27740.

Now, out of this 26000 dollars of material that you have utilised, out of this 26000 dollars of material that you have utilised out there, 1950 dollars of material is you have used it from already the stock which is there in the godown. So, you have not made that any purchase in that case. So, what do I do, I reduce that basically to account for what is the money that I am liable to pay on the purchases that I have made this particular year. Am I with you or not?

Student: Yes sir.

So far so clear? But you also see some goods still in the inventory at the end of this year also some more raw material. That means, you are not only bought for 26000, you have bought additional material which is also lying in the what we you call it as godown this particular year as of now. So, what is the additional material that is what we normally call it as closing inventory is about 900 is basically the amount out there, and that will give me something around 26690 is basically that kind of number what we have.

So, what did I do out here, first I looked at the creditors alone, do not confuse both. Sir, you are accounting for creditors, you are also accounting for inventory, no, these two are separate creditors are where on the liability side of the balance sheet, separate. Inventory is where on the asset side of the balance sheet – separate. Do not mix both. It is something like is say when you take a loan from a bank what happens, your cash also increases, your liability also increases. Yes or no?

Student: Yes.

Yes, otherwise what we initially first class what are the confusion. No, that is cash what I have is a loan, cash I what I have is a loan that is the kind of argument what I had. I said if the cash gets stolen who is liable, bank is liable or you are liable, you are liable because you own it, similar. One second Swapnika. So, what happens, in this particular case, treat it both independent treat both independent out there. First what we look at as of creditors what is the money. Second what we looked at the amount of material that you have utilised number of units; you can even convert it to units and see that.

So, what are we did I have there are some inventory which is opening I used it. There are some additional inventory which was left, basically it will not the inverter which is left will never appear in the P & L statement, because P & L statement will take only material which is.

Student: Utilised.

Utilised as of this particular year. So, what happens I have reduced that part of it, I added the material that was basically what do you call it as which was which is in the inventory at the end of the year, and basically have arrived at what do we call it as 26690 is the amount of cash outflow that is occurred because of an operating activity.