Financial Statements Analysis & Reporting
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Lecture – 52
Cash Flow Statement - Introduction Part – I

Welcome students. So, now, we are going to talk about the next technique use of financial statement analysis and this technique is the cash flow statement. By preparing the cash flow statement we are now going to understand the performance of the company or what is defected by the financial statements and what is the overall cash position of the firm. You see that why there is important for the cash management or the preparing the cash flow statement; cash flow statement.

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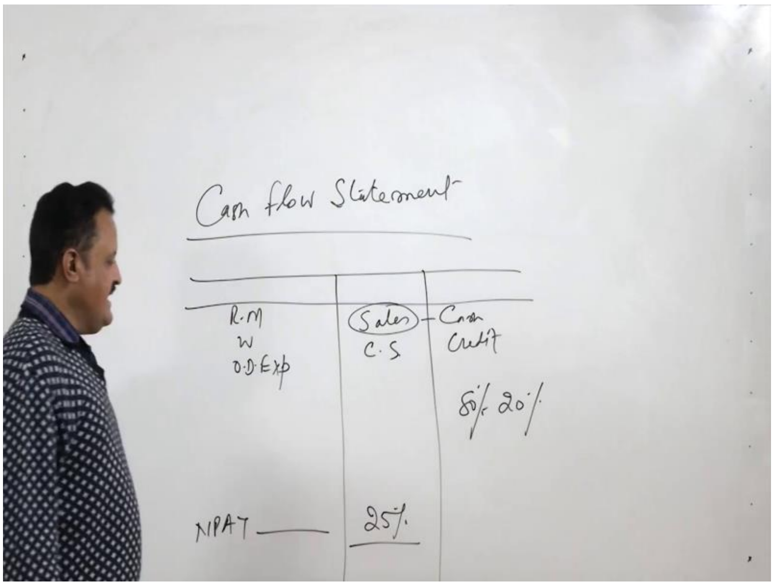

We prepare the cash flow statement and why there is a need for preparing the cash flow statement because when you prepare the profit and loss account we have discussed it earlier also, but let us recall it again this time you are taking sales it is sales and you are taking the closing stock and here you are taking the expenses that is the raw materials, wages and the other direct expenses. These are the 3 things. So, we are taking here the sales and are we writing here the sales are on cash how many shares are on cash and how many how much sales are on credit are we writing like this? We are not writing like this, we are writing that the sales, then the sales are sales and no distinction between the cash sales or the credit sales in that situation in that situation if for example, some form is selling in the market and that to the ratio is 80-20.

80 percent of the sales are on credit and 20 percent sales are on cash. So, finally, when the net profit after tax we are working out here and that profit works out as here is 25 percent, but again this profit you have to segregate into that in the ratio of 80-20. So, in that case also, you would have to find out that my 20 percent of the profit is on credit and 25 percent is only on cash see wherever the ratio works out.

So, this is a very very dangerous position for the firms this kind of the firms; the firms having this kind of the balance sheet or the profit and loss account cannot sustain much longer they will have to stop their business and they will have to be closed down because their credit sales are going to put them in the trouble because we see that when there are credit sales there are the bad debts also and higher the amount of credit sales higher the amount of bad debts higher the amount of credit sales. There is the higher the amount of the bad debts and if the larger chunk of the bad debts are there it means by you are selling on the credit and what you are talking here as the profit for why you are talking here as the profit for if there is no profit as such we are say misguiding the people misguiding the investors misguiding the lenders misguiding the suppliers.

Everybody's stake is at risk; everybody's stake is at risk. So, this is the one important question that we have to address while preparing the cash flow statement and you see the foolishness of the company management is that when they are selling 80 percent on the credit and here. Means when the sales are growing because you sell to anybody on credit people are ready to buy it they have not to pay, they have not to pay to the company at the moment they receive the inventory or they receive the consignment they will sell that consignment in the market later on they will keep their own profit with them and then they will rebate the company's part to the company and sometimes we can say that I could not sell in the market or I sold to somebody for else further in the credit he has not paid it back to me. So, far so if he pays me if he pays me I will pay it to you if he does not pay me I cannot pay you.

So, it means in that case the bad debt will be also further the position or the magnitude or the extent of the bad debt will be further aggravate. So, in this situation and another important say negative point of this kind of the sales and selling process is that when you are selling in the market on credit your sales are growing and consequently your profit is also growing and when your profit is growing your tax obligation on the profit is also growing your tax obligation on the profit is also growing it means you are paying the tax on those sales even which you have not collected. So far, those sales which you have not collected so far, you are paying the tax on those sales even. So, it means any income which has not come to me and I am paying the tax on that what kind of the business I am doing.

So, there lies the importance of the cash flow statement that yes we have to prepare the cash flow statement and we should be knowing that while preparing the cash flow statement when any amount if the profit is shown by the company and equal amount of the cash is not there in the bank account of the company. It means if the profit making company it must be cash profit and the balances of the cash and the bank balance of that year should be say comparable to a profit maybe something maybe it can be 90-10 or 80-20 difference can be there that 80 percent of the profit is cash profit and 20 percent is the credit profit accepted. But if it is a 20-80 that 20 percent is cash 80 percent is credit it means you can make out that if you are going to deal with this kind of the company's then you are going to put yourself in trouble.

So, we want to verify that if the company is posing as a profit making organization excellently doing organization having the largest market share in the market you tell us whether the profit you are showing in the profit and loss account is cash profit or larger chunk of the profit is only the credit profit or it is a pseudo profit or it is a nominal profit that is the million dollar question we are going to address here. So, then I am talking to you about the cash flow statement, let us talk about the some important aspects of the cash management.

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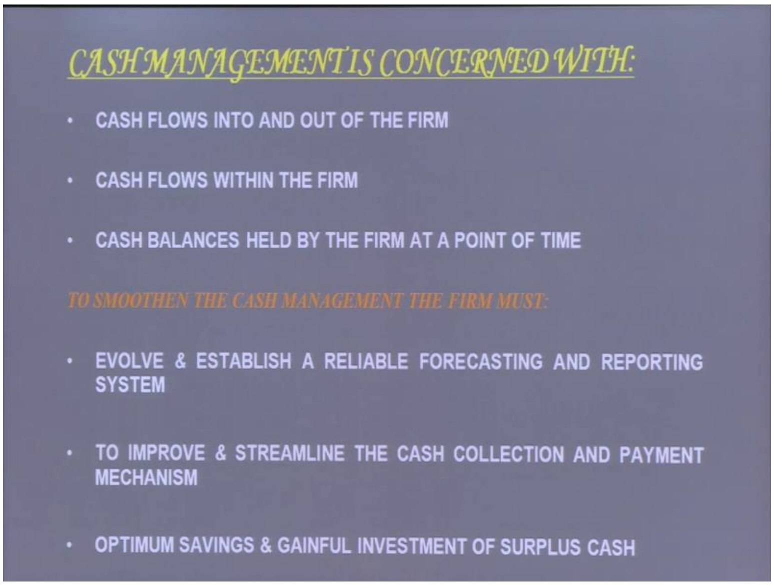

Some important aspects of the cash management because as I told you 2 financial analysts you must be knowing the background of the cash management and then the need for preparing the cash flow statement that the cash management as a whole is concerned what its concerned with the 3 important issues first issue is cash flow into and out of the firm cash flow within the firm and cash balance is held by the firm at a point of time cash balance is held by the firm at a point of time cash flow into and out of the firm. So, it means by preparing the cash flow statement we are going to study from where the cash or how much cash flows into the firm and how much cash flows out of the firm for example, we are buying raw material we are paying wages we are paying other direct and indirect expenses and we are earning some incomes also.

So, if we are producing something and selling something, if we are producing something, cash is flowing out because we are buying so many inputs and if most of the inputs are coming on cash. So, it means you have to pay the cash and compare that how much cash is flowing in by way of sales by way of indirect incomes and so many other things how much cash is flowing in? So, how much cash is flowing out how much cash is flowing in you have to make out for that and by preparing the cash flow statement you can easily make out that yes what is my cash position or others who are the external stake holders to the company. They can easily make out what is the cash position with this firm if the cash position is not there then firm selling on the credit in the lust of increasing their market share pseudo market share or in the lust of making maximum sales in the market they can soon become the sick firms sick organizations and they will not be justifying with their investors their lenders or with their suppliers this is one important component.

Second is cash flow within the firm you see that when you talk about the liquidity in the firm that is defined in the form of cash when you talk about the liquidity in the firm that is defined in the form of cash and what is the true liquidity? It is not true liquidity that you have sufficient amount of the cash in the firm, true liquidity is say they are the different departments in the firm different divisions and sub divisions in the firm and they have the they all have their definition of liquidity they all have the definition of liquidity.

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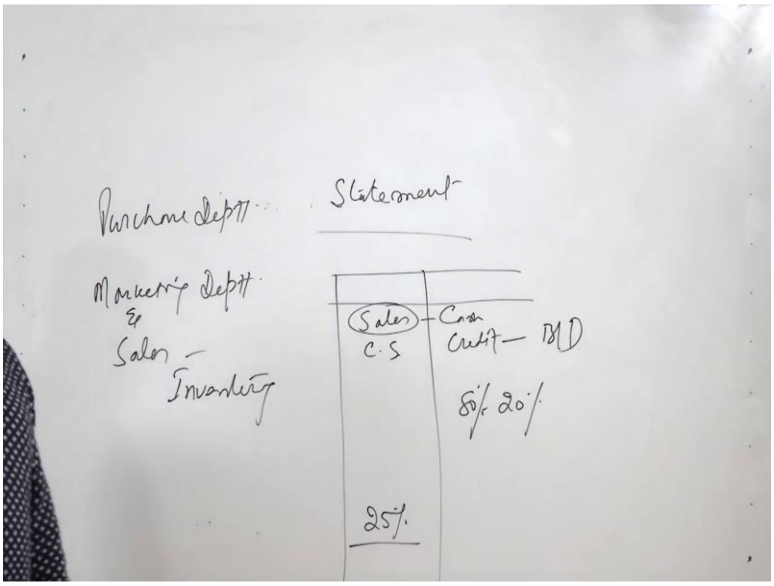

For example you talk about the purchase department in the firm first because first of all if you have to start the manufacturing process you have to buy the raw material and if you have to buy the raw material it means you have to purchase the raw material purchase the raw material means you have to have the funds for that. So, what is the liquidity for the purchase department is having sufficient amount of funds with the purchase department or being provided by the finance to the purchase is the liquidity yes that is the liquidity one part, but the second part of the liquidity is that the purchase department is having sufficient funds sufficient cash for buying the raw material and being provided by the finance also by the finance department, but there is no raw material in the market there is no raw material in the market. So, what is the purpose of that liquidity?

So, liquidity for the purchase department is having cash one and having sufficient material in the market 2, this is the liquidity similarly you talk about the; and that way for the production also there is no purpose of liquidity because purchase will not be there. So, production will not be there. So, production department is also requesting for the or asking for the cash liquidity and for the material liquidity similarly we talk about the liquidity for the say your marketing department liquidity for the marketing department when you talk about the liquidity for the marketing department maybe or sales department marketing and sales both we talk about marketing and sales department.

Now what is the liquidity for the sales department? Sales liquidity for the sales department is yes when they sell in the market and if they sell a maximum part of their production in the market on cash they are generating sufficient liquidity for the firm, but if there is a demand for the firms product in the market marketing and sales people are getting the frequent request from the different say channels of distributions in the market, but the company has say no say output and no inventory company has no inventory, but the marketing and sales people will sell in the market you have funds, but no inventory there is no production it means the liquidity for the sales people is useless. So, because it is getting affected its having a circular process when the purchase department could not process because there was no raw material in the market production department could not produce because they did not get any production material from the purchase and then marketing people do not have anything in the ground to sell in the ware house to sell because there is no output there is no inventory nothing.

So, it means what is the purpose of that liquidity. So, we have to ensure the liquidity from both the angles that there is cash also and there is a material also. So, if there is a possibility that in the future course of action you might face the shortage of a particular kind of a material in the market. So, you have to buy in the current period you have to buy the maximum and when you buy maximum you need maximum cash today not tomorrow. So, you need more liquidity today and all the times all the years all the days all the months we do not need the same amount of cash, but still we have to be careful that how the cash is flowing within the firm and if the cash is flowing properly from the one department to the other and other department to the other then there is no issue there is no problem and easily the situation can be managed.

Then cash balance is held by the firm at a point of time as I told you that holding of the current assets and cash is also the one important current asset. So, you have to keep optimum amount of the cash in the firm it means by looking at the cash balance with the firm at a time you can easily make out if the balance held by the firm is very high in that case you can say that that case you can say that the firm is a poor manager of cash they do not realize. But that the keeping high amount of the cash as a cost and if the cash balance is low then always the firm is in a vulnerable position because there is a possibility of firm facing the technical insolvency any time any payment becoming due to be made any current liability is becoming due to be paid and the firm does not have the cash.

So, we have to maintain a optimum amount of the cash and the optimum amount of the cash we have to decide depending upon the operations of the firm depend upon the production process sales and other requirements we have to decide that what is the optimum amount of the cash. So, you have to look it at while preparing the cash flow statement you have not to look not only the existence of the cash how much cash is there one and we have to see that if the firm cash is flowing means efficiently within the different departments of the firm in that case you are sure that because all the means the your production is sufficient your sales are sufficient your sales revenue is sufficient your profitability is sufficient and your cash is sufficient. So, one thing cash is affecting everything.

Cash is basically called as the life blood of the company. So, if the say for example, in the human body if the life blood means the blood in the human body is more it is not good if it is less anemic similarly in the company. So, we have to have optimum amount of the blood in the human body similarly in the company if there is more cash it means we are over capitalized we are over liquid firm extra liquid firm and that is not good because it will increase the cost it will not earn anything for you. Similarly if we are under cash then in that case it is again its affecting firm will be anemic firm will be technically proven to become technically insolvent and firm will become almost some time a bad performer. So, we have to maintain the required amount of the blood required amount of the cash in the firm all the times we have to keep it. So, these are the 3 important issues we are going to know with the help of cash flow statement or by preparing the cash flow statement.

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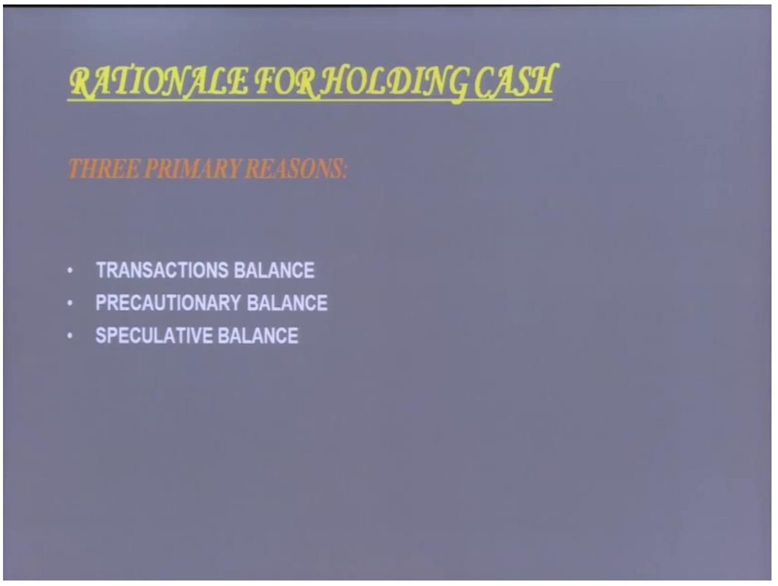

Now, the next thing is that why the firms keep the cash? Why the cash is required? They have the 3 motives like inventory if I had gone through the inventory process like inventory the cash is required for 3 purposes one is for the transactions. So, we call it the transactions making the payment receiving the payments receiving the receipt making the payments we need the cash precautionary balance we always maintain a minimum level of the cash we never allow the balance of the cash go below that particular level if that goes below that level it means firm can at any time become technically solvent any payment becoming due to be made firm does not have the sufficient liquidity sufficient cash. So, for that reason precautionary balance is required and third is the speculative balance sometimes you get the opportunity in the market that you have a special type of material is easily available in the market which is otherwise not. So, it is better if we buy that material and store it today because its easily available one and it is available at the acceptable price.

So, it means in that case for the; or it can be possible that you buy this material today in bulk at the very cheap prices and then you sell it tomorrow at the very high prices. So, it means in that case also for that is called as a speculation because you buy today store it and you are expecting demand for that will increase tomorrow, but if it does not increase then your speculation goes wrong.

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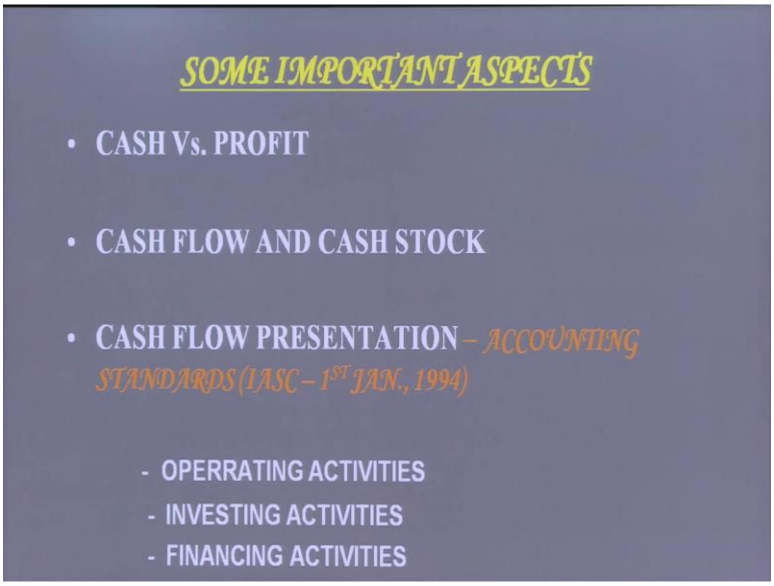

So, for the speculative purposes we keep cash we use cash and sometime if our speculations go right we earn best return by investing that cash on the speculating purposes now here are the other important very useful other important concepts they are like the cash versus profit cash flow and cash stock and cash flow presentation.

Cash versus profit you are going to be now after this a good financial analyst because you are studying this subject that is the financial stage analysis and reporting. So, do you feel that having profit by the firms is sufficient is it only requirement of the firm that they should be earning the profits or something more than that we have only discussed here at length by preparing. Means looking at this profit and loss account and when we prepare this profit and account I have told you sometimes in the past also back also that when you prepare the cash this profit and loss account and you calculate that profit maybe the gross profit or the net profit finally, it will be the result is to net profit from where which account you are getting that profit and loss account profit and loss statement and what is the profit and loss statement.

It has incomes and gains on the credit side and it has the expense and losses on the debit side and where this rule applies on which type of accounts nominal accounts. So, profit is nominal which is given to you by the nominal statement it means the profit is nominal and the cash is real. So, we have to be careful here that you have cash profits or you have only profits if the cash profits are there then you can boost all of that yes my profit is the cash profit and that is the real profit because cash is real cash is the asset and asset is the real account. So, cash is real profit is nominal. So, having earning profit only is not sufficient you should have the cash profits this is one important thing if you earn only profits and feel satisfied that my profit will come tomorrow you have sold on credit you are illuming that you will be able to collect all the sales because part of the sales will become the bad debts and their profit will never come to us we have already discussed that length.

Second thing is cash flow and cash stocks cash flow and cash stock you have sufficient cash, but if it is lying as a stock and it is not flowing well pick up the balance sheet of any public sector company who is a profit making company I tell you pick up the balance sheet of VHL or any other public sector company, you will find huge amount of cash lying in the balance sheet of that company and nobody is concerned about the use of that cash they have huge cash huge collections and entire amount of the cash after paying all their obligations, salaries, administrative expenses, selling, advertisement, all kind of expenses still huge amount of cash is lying in the balance sheet of VSUs because they do not know and they are not concerned with real management of cash. So, true manager financial manager or the chief financial officer of the company he should be knowing it that keeping high amount of the cash is not good.

So, you have to make out by preparing the cash flow statement that you have the cash stock or you have the cash flow cash is flowing in the firm from the one department to other to other and if there is a surplus cash then it is flowing out of the firm and being invested in the marketable securities short term securities that is a good strategy and if the cash is kept as a stock means its flowing, but it is kept. So, much in quantity in quantum in the amount that this much cash is not required in the firm it means why are you keeping so much of the cash? Do not you know that keeping cash is a costly affair it does not earn anything for you but it has a cost. So, it means keeping cash in the firm of the cash stock is not good for us.

Cash must be flowing and we should not keep the stock of the cash we are going to find out with the help of cash flow statement that what is the quantum of cash, cash is flowing or the cash is static third important thing is the cash flow presentation cash flow presentation or preparing the cash flow statement earlier when we were preparing the cash flow statement we were starting with we were starting with the we are preparing a simple cash flow statement that we were starting with the total profits of the firm net profit or profit after tax and then we were adding back certain non cash expenses and then we were subtracting the cash outflows. So, we were adding the cash inflows and the non cash items and we were subtracting the cash outflows and we were finding out that this is my closing cash balance and that was easily tally able with the balance given in the balance sheet that was there that was the process, but now the process has changed.

From 1st January 1994, internationally there was a development with regard to the cash flow statement and international accounting standard committee IASC on 1st January 1994 changed the process of preparing the cash flow statement changed the process of preparing the cash flow statement and IASC said that now the cash flow statement means there were the 2 developments, one that cash flow statement will be the statutory statement now required along with the income statement and the balance sheet it will be a third statutory statement required and to be provided to all the stake holders it will be means it will be the part of the balance sheet. And every firm has to prepare who is following the international accounting standards they will have to prepare compulsory the income statement that is the profit and loss account balance sheet and the cash flow statement that was the one development and the second development was that now the cash flow statement will not be a simple composite cash flow statement.

But this has to be prepared in a different manner and cash flow has to be shown under these 3 activities operating cash flow cash inflow and cash outflow on account of the operating activities cash inflow and cash outflow on account of the investing activities and cash inflow and cash outflow on account of the financing activities.

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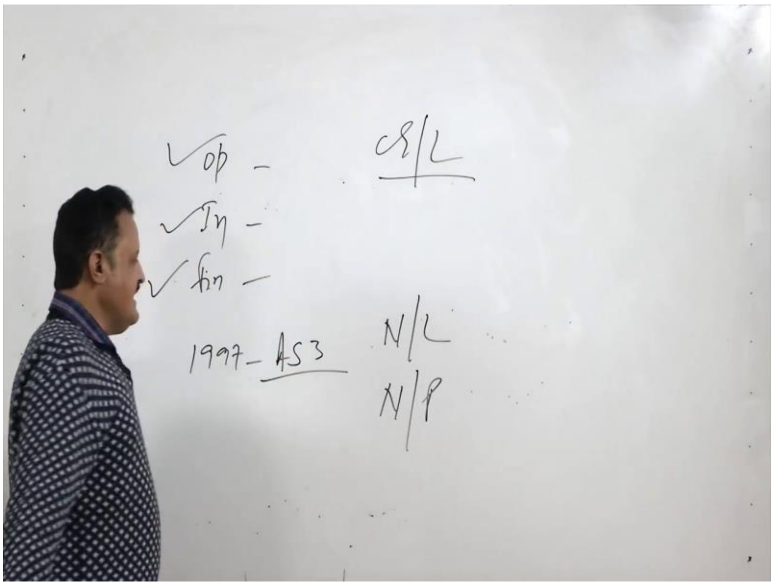

These 3 activities we will have to show the cash flow. So, that we can easily make out why these cash flow of operating activities investing activities and financing activities I discussed that length with you some time in the previous lectures that as I told you, I gave you the example of the Videocon and I have told you that when you calculate the gross profit of the company you will get that is not a gross profit rather a gross loss. So, if you talk about the operations of the Videocon and Onida they are very poor, but at the end of the profit and loss statement if it is a gross loss here then it should be net loss here, but it is not the net loss it is the net profit because larger chunk of the cash is flowing in Videocon and Onida not from operations. But from the investing activities or from the financing activities is Videocon a investment company is Videocon a financing company if the Videocon is a manufacturing organization major chunk of the cash must be flowing in from the operations.

Second thing is yes there can be the inflow of the cash from the investing activities and there can be cash from the financing activities, but the magnitude of that cash must be the minimum must be after the operations first it should be the major contribution should be from the operations and then from the investing activities and then from the financing activities. So, now, today when we prepare the cash flow statement we prepare under this format that we divide the total inflow into the cash flow from operating activities investing activities and financial activities in India though IASC accepted this standard in 1994; 1st January 1994, but in India this standard was this change was adopted and made effective from 1997.

In 1997 institute of chartered accountants of India, they introduced a new standard which is called as AS 3, under AS 3 now in India also the preparation of the cash flow statement is mandatory requirement its now statutory requirement. So, along with the balance sheet now in India also the third statement required is the cash flow statement and the cash flow statement has to be prepared under this process cash flow from operations cash flow from investing activities cash flow from financing activities and it has to be prepared in this fashion this manner and this style.

So, in India now from 1997 also it has become mandatory it has become compulsory and it has to be prepared in that manner and in that way that is cash flow is shown under the 3 activities. So, that any stake holder maybe he is a investor he is a lender he is a supplier he can easily make out what is the future of this company if the nature is a manufacturing firm and if the major outcome of the cash is from the operations fine then it can be from investing also it can be from financing also, but if it is more from investing and financing less from operations you can make out that the operating structure of the firm is poor financial structure is good. So, very soon the poor operating structure would eat away the strong financial structure also and soon this company maybe a sick firm my investments my supplies my payments are not safe and secured in this company. So, I should not deal with this company. So, I should not do the business

So, for the reporting purpose in India reporting of the financial statements now this statement has also become compulsory and in India also under say AS 3 now the cash flow statement has to be prepared under the 3 activities operating investing and financing and that composite statement is now of not the any requirement, but when we are preparing the cash flow statement we are starting with the composite cash flow statement we are preparing a basic cash flow statement then we are doing some analysis and after that we are preparing the final cash flow statement and that final cash flow statement is again based upon this. So, you have to confirm that the balance of the cash given in the balance sheet is true number one you will be confirming by preparing both the statements basic cash flow statement. And the final cash flow statement and at the same time you will get the second answer that whatever the cash flow we are showing in the balance sheet and proven by the this cash flow statement how much it is coming from the operations how much from the investing activities and how much from the financing activities.

So, what are the operating activities considered under AS 3 and the ISCs standards and investing and financing activities first we will learn that what are the operating activities what are the investing activities what are the financing activities after that we will start we will we will learn how to prepare the cash flow statement under this new standard AS 3 and then how to analyze that statement that discussion I will do with you in my next part of the discussion in the next lecture till then.

Thank you very much.