Financial Statements Analysis and Reporting
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Lecture – 53
Cash Flow statement Part – II Continued

Welcome students. So, we are in the process of learning about the cash flow statement. I discussed in my previous lecture, the importance of the cash flow statement and the requirement of the cash flow statement. And as I told you that it has become now a since 1997, after the introduction of AS3 accounting standard three which was developed by the Institute of Chartered Accountants of India because in India, ICAI.

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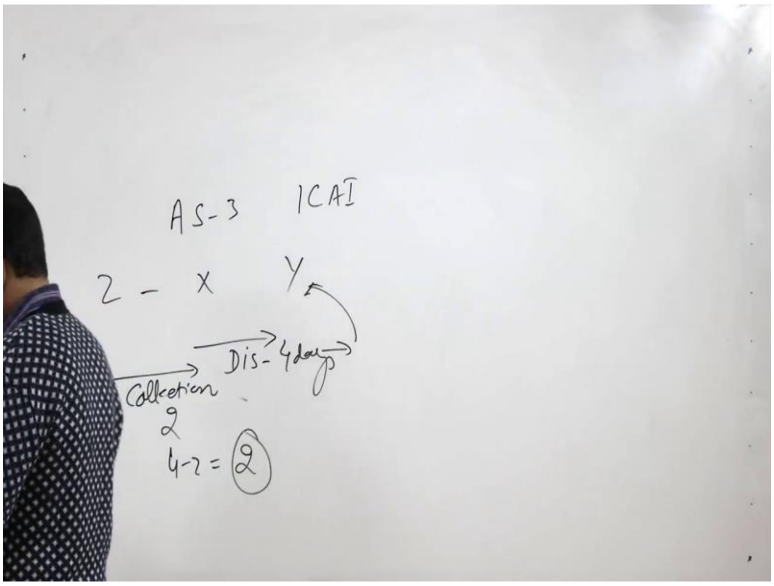

Institute of Chartered Accountants of India is the body which develops the standards for accounting systems in India. So, after the say introduction of this standard by International Accounting Standard Committee on to first January 1994 in India Institute of Chartered Accountants of India accepted this change under AS3 under accounting standard 3, and since 1997 in India also this statement has become important this statement has become mandatory. And now apart from the income statement and balance sheet, the cash flow statement also has to be prepared by the companies and especially by the joint stock companies' public limited companies has to be submitted to the different stakeholders.

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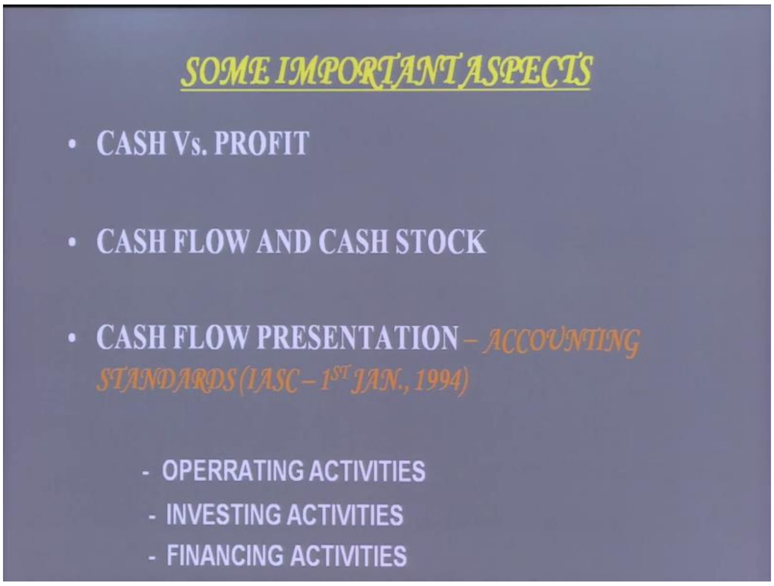

So, as I was talking to you in the previous lecture that now the change in the new cash flow statement and the as compared to the old cash flow statement is that. Now, the cash flow statement has to be prepared under three broad say headings or the activities that is operating activities, and then investing activities, and then the financing activities. So, that we are easily able to make out that how much cash is flowing in from operations or operating activities, how much cash is coming in from investing activities, and how much cash is coming in from the financing activities.

So, that the companies who are the manufacturing organizations, if they are incurring a loss under the operations and having a profit from investing and financing activities, they are exposed. They are able to means they are not able to hide this fact that their operations are poor, but from the other sources they are getting the income like Videocon and Onida, and finally they have the profit, so that people review investor's lenders or suppliers do not feel disguised.

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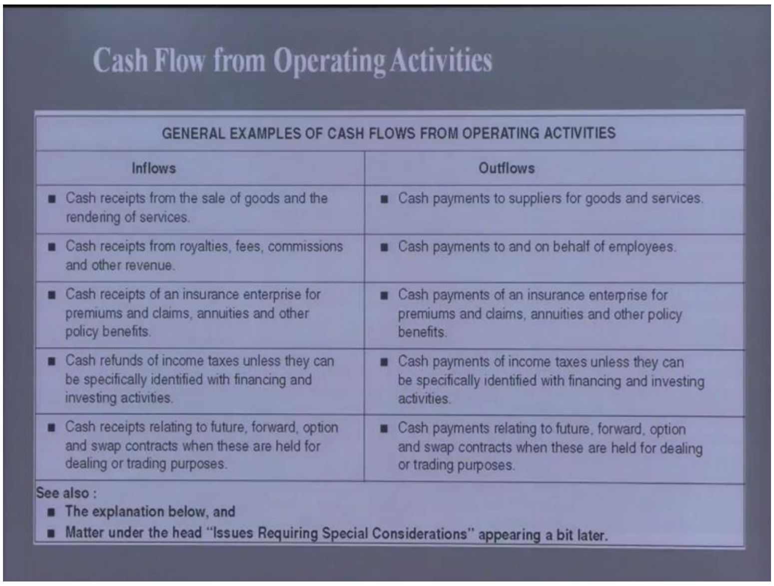

So, now until this process and this new statement we are going to prepare and learn how to prepare then we will find it out that what are the activities called as the operating activities. What are the activities? We should be very clear before learning it because tomorrow if you have to prepare the cash flow statement yourself under AS3 then you should be clear that what is the AS3, and what is the requirement of AS3, and what are the activities called as the operating activities and under this tender. And when we talk about then the operating activities are these activities, and we have to consider the cash coming in from these activities as the cash flow from the operations. So, you see talk about this side, it is talking about the inflows. So, this is inflows of the cash and these are the activities or heads on account of which the cash is flowing out.

So, say for example, cash inflow is on account of the cash received from the sale of goods and rendering of services. If it is a manufacturing organization, the sale of goods; if it is a the service rendering organization then any cash is flowing in on the sale of services then yes say for example, some company is giving the IT services, now whatever they are not manufacturing any product. So, whatever the services they are given to a say to their clients cash flowing in from those is considered as the cash from operations, this is the first activity.

Then cash receipt from the royalty, fees, commission and other revenues, any kind of the say patents company has given technology has given any kind of the say copyrights the company has given to the other companies, it means this is because of their better manufacturing product process somebody else is using that. So, for example, the drug manufacturing companies; now drug manufacturing company Cipla or Dr. Reddy or somebody else, if they have some good say patents of the drugs and if they have given those drugs rented them out and say other companies are manufacturing the drugs by using those patents. Then in that case that income for the Cipla or the Dr. Reddy’s lab will be considered as income from operations.

Similarly, cash receipts from of an insurance enterprise for premiums and claims, annuities and other policy benefits. If it is a insurance company then the premium incomes, claims or any kind of the other incomes they are receiving that is which is basically insurance type of the income. And lastly the source of income is the premium and then the some annuities, say for example, some government policies they have sold, and annually the government is paying then the big amount of the premium say for example, from the railways if LIC receives the largest chunk of premium from the railways in the form of the annuities that all income is called as the income from operations, for the insurance company.

Similarly, cash refunds of income tax, unless they can be specifically rectified with functioning a financing and the investing activities. Of course, in India there is a system of the advance tax payment, quarterly tax payment companies do is considering their sales labor or expected labor of the sales, every quarter the companies pay tax in advance, companies not pay tax at the end of the year they made in the payment of the advance tax to the government. So, they keep on paying the tax on the basis of the estimated sales.

And at the end of the year they calculate that how much total sales are there, how much total profit is there, how much tax was due to be paid by that company to the government. And for example, under advance tax, some say under advance tax process if more tax has been paid then what is actually due at the end of the year in that case that advance tax has means that extra tax, surplus tax paid by this company has to be refunded back by the income tax department to the company. So, if it is relating to the manufacturing business, which the companies involved into then that refund of the tax is also the considered as a income from operations.

Cash receipts relating to the future, forward, options and swap contracts when these are held for dealing or trading purposes; if any cash is received on account of this, these are the derivative products, these are futures, forward, options and swaps these are the derivative products. And any cash received on an account of these derivative products, we will have to consider it. Say for example, now the company is entering into two protect its share price in the market or if the company has some investment means have that kind of the say forward agreements or some future agreements or options agreement, say for example, there is a interested swaps. Now companies say borrowing would not to borrow at the fixed rate of interest for the bank is ready to give the loan to the company at the fluctuating rate of interest or the variable rate of interest.

So, when the company has to do, company has to borrow from the banker the variable rate of interest and to swap the interest with the other companies who is interested to take the loan from the bank at the variable rate of interest for the bank is ready to give them to the at the fixed rate of interest. So, if there is any kind of this because of that interest rate swap, if any income is there that income will be derivatives income, and that will be considered as, but that swap that borrowing that loan and the swap should have been for the trading purpose not for the investing or financing purposes are for the speculations. In that case, if it is for the trading purpose then there is no issue it can be considered as the cash from operations.

And here are the sources of or maybe the avenues of the outflow, and they are in terms of cash payments to the suppliers for goods and services. When it is a manufacturing organization they are buying the raw material they are may be getting some services. So, maybe it is a service rendering organization for example, IT service rendering organization and this company before giving the services to its their final clients, they also get some software developed from there say suppliers. So, in that case if they are getting any service or raw material for any purchases they are making that is also the operating outflow.

Then cash payments to and on behalf of the employees when salaries are paid to employees, wages are paid to workers, any bonus, any kind of the other benefits. If for examples if the company’s employees are insured and companies making the payment of their insurance premium to the insurance company review on the behalf of their employees for the company’s employees, company is getting them insured then that payment is also considered as the operating outflow. Cash payments of income taxes unless they can be specifically identified with the financing and investing activities; all kind of the income tax payments, if they are only on the profit from the operations; any profit from the operations and any tax is paid on account of that that has to be considered as the operating cash flow and that has can be taken into account.

And similarly, here as inflow is there on account of derivatives, here outflows can be there for the derivatives. So, any account, any outflow of the interest on account of the derivatives, if it is flowing out any payment of the interest if the government company has to make on account of any derivative products, if company has to pay some cash and cash outflow takes place. And those derivatives which are used for the trading purpose. Then that outflow is also considered as the say cash outflow on account of the operating activities.

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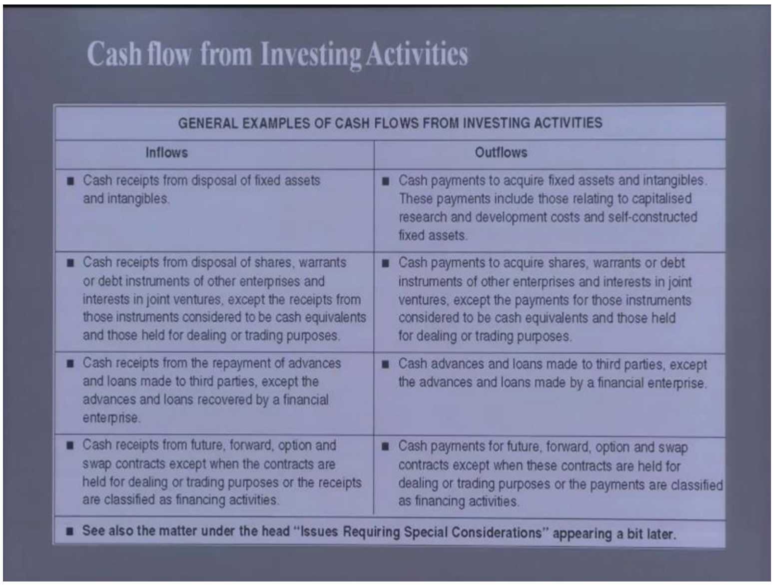

GENERAL EXAMPLES OF CASH FLOWS FROM INVESTING ACTIVITIES

Inflows	Outflows
■ Cash receipts from disposal of fixed assets and intangibles.	■ Cash payments to acquire fixed assets and intangibles. These payments include those relating to capitalised research and development costs and self-constructed fixed assets.
■ Cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures, except the receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes.	■ Cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures, except the payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes.
■ Cash receipts from the repayment of advances and loans made to third parties, except the advances and loans recovered by a financial enterprise.	■ Cash advances and loans made to third parties, except the advances and loans made by a financial enterprise.
■ Cash receipts from future, forward, option and swap contracts except when the contracts are held for dealing or trading purposes or the receipts are classified as financing activities.	■ Cash payments for future, forward, option and swap contracts except when these contracts are held for dealing or trading purposes or the payments are classified as financing activities.
■ See also the matter under the head "Issues Requiring Special Considerations" appearing a bit later.	

Then we talk about the cash flow from investing activities. Here again we have to look at the same thing investing what are the investments basically. What are the investments and what are the investing activities as per the international accounting standard committee and the same thing as it is interpreted and accepted in the Indian scenario by the Institute of Chartered Accountants of India under the accounting standard 3. So, inflows on account of investing activities that is cash receipts from the disposal of the fixed assets and tangible. In tangibles if company has some machinery and that machinery now has become useless and if it is sold for a place where the new machine then the sale proceeds of that is bringing in some cash to the firm, so that is also considered as a cash inflow from the sale of the fixed assets of the tangible assets.

Cash receipts for disposal of shares, warrants or debt instruments of other enterprises and interest in joint ventures, except the receipts from those instruments considered to be cash equivalents and those for held for dealing or the trading purpose. So, any investment if this company or a company in question has made in the other company if that is sold in the market, the share is sold in the market or share in the joint venture sold in the market then that income that influence is also considered as inflow from the investing activities. Provided that inflow is not on account of those shares which are here for the trading purpose his own company. His only investment where outside if that investment share is sold in the market in that case yes that is the investing inflow.

Cash received from the repayment of advances and loans made to third party, except advances and loans recovered by a financial enterprise. If it is a manufacturing company, and if they had given some loan to somebody, and now that loan is coming back say for example, we have the loans and advances as the current assets, if that loan is coming back that inflow is also considered because that loan was given with the intention of investing the surplus cash out. So, that is the inflow coming back is that is considered as the investing inflow.

Then we have the cash received from future, forward, options and swap contracts except when the contracts are held for dealing or trading purposes further seats are classified as financing activities. Any investment if its only investment made in any kind of the futures and forward contracts, and if any cash is received from those future or forward contracts that is also considered as the because that is held only for the investment purpose.

Earlier I told you that is interested swaps that is that was only for safe making the operations smooth and we need the funds for that. So, we have to use the interested swaps. So, using the interested swaps for the trading purpose is different and using the swaps and this futures, and forwards, and options for the investment purpose is different. So, we have to look at the purpose. And if any cash is flowing in from any kind of the derivatives which is not for the trading purpose, they were not held for the trading purpose, they were for the interesting purpose, and investment purpose that this is inflow is considered as investing cash inflow.

Similarly, that if it is the inflow on the sale of assets, so when we purchase the fixed assets we call it as the investing outflow. When any plant, building, machinery, land purchase by the company for making its business smooth then it is called as the investment and investment is means investment in the assets is fixed assets is considered as the cash outflow for buying those fix assets is the outflow occurring on account of the purchase of the fixed assets.

Cash payment to acquire fixed assets and intangibles may be any copyright patent we have to use, so that is basically intangible that is only a right; that is only a patent. If we are going to use that and we are paying any price for that and that is going to be asset with the form, is any patent is with the companies buying temporarily, any copyright company is buying temporarily then till the time it is used by the company. It is considered as asset as good as a tangible asset. So, when cash paid out for that purposes that as considered as the investing cash outflow cash.

Payments to acquire share warrants or debt instruments of other enterprises, and interest in joint ventures means when we are selling the shares purchase early that is against only for the investment purpose that is inflow. And for buying the shares in the other enterprises of all of the other enterprises or in the joint ventures of all companies accept they are not held for the trading purpose in that case that is considered for buying any kind of investment, instruments even mutual funds that is considered as the investing cash outflow.

Then cash advances and loans way to third party except the advances and loans made by the financial enterprise. When we make investment of the surplus funds outside the company, we give the loans and advances to the people. So, as it is a inflow here, similarly when the loan are received back, it is inflow investing inflow and then the loans are given then they are investing outflow.

Similarly, cash payment for the future, forward, options and swap contracts, except when these contracts are held for the dealing for the trading purpose. If you have any if you by any kind of the contracts swaps, future, forwards, options. Then basically yes it is a cash outflow because we are buying these instruments with the investment purpose not for the trading purpose. So, these are the say activities considered as investing activities, and any kind of inflow or outflow taking place on account of these activities is called as the cash flow from the investing activities.

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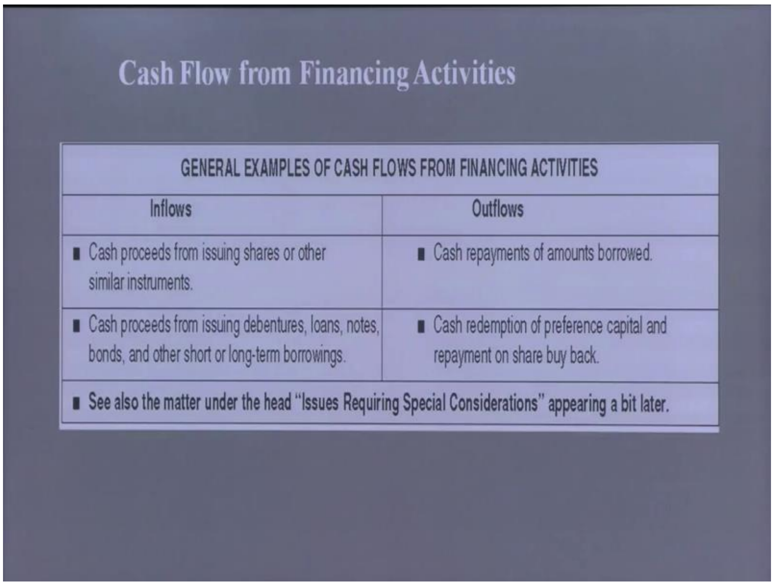

Similarly, if we talk about the next part, that is the cash flow from the financing activities. Now, what are the finishing activities, they are also clearly categorized. So, see the examples are cash proceeds from issuing shares or the other similar instruments, financing; generating resources for or sources of finance for the firm. If you are issuing any shares in the market companies coming out with and IPO or FPO or issuing any shares in the market then that say inflow of the funds coming in capital inflow or the share funds inflow coming on account of the sharing capital that is considered as a financing inflow. And similarly, when the cash is repaid back, for example; companies buying back the shares mean returning the money and buying back the shares. Similarly, when the company is say returning the loans back means any borrowed money, if it is being returned back then it is considered as the financing outflow.

And then next thing is cash proceeds from issue debentures, loans, notes, bonds and other short or the long-term borrowings. When we are boring the funds, it is a inflow; and when they are being redeemed or being paid back, so that is consider as the cash outflow on account of the financing activities. So, these are the two broad sources normally the long-term sources with the forms are what number one is the share capital second is the loans, and debentures, and bonds. So, when the shares are issued cash is received, it is a inflow; when the loans are taken and debenture or bonds are issued again inflow, then the shares are being brought back it is the outflow. And similarly when the loans are the being returned or debentures are being redeemed bonds are being redeemed it is considered as a finishing outflow.

So, these are the very clearly defined activities, three kinds of the activities that is operating, investing and financing activities. And we have to clearly categorize it that how much cash is flowing in and going out on account of the operations, how much cash is flowing in and going out on account of the investments, and how much cash is flowing in and going out on account of the financing activities. So, that you can it can be possible that even a manufacturing organization though they are incurring a loss in say last two, three, four years is a lose making organization, but say they had surplus land. And in one particular year, they sold the land worth rupees say 20 crores, and because of that inflow of the cash we have got now say positive cash flow or the balance shown in the cash balance sheet, cash balance shown in the balance sheet is a is a very hefty amount will be very good amount.

So, we may be confused that this cash is or inflow or the cash balance is because of the high profitability of the forms; whereas it is not the case, it is by selling the fixed assets in the market. So, when it happens we should be able to any outsider who is not involved in today affairs of the company he should be able to make out that this cash is flowing in on account of the sale of fixed asset not because of any other reason, so that is the important issue. So, we have to say differentiate that is what is considered as a operating inflow, what is considered as the investing inflow and what is considered as the financing sources of the cash inflow and outflow both, and then we will have to take the necessary decisions.

Here we talk about the something little about the liquidity management. So, when we talk about the liquidity management, so as I told you earlier also that firms to maintain the liquidity, they should have sufficient amount of the cash they should have sufficient amount of the cash, but you see when we have cash or we keep cash that. I have also the share this in with you that keeping a large amount of the cash is also not good, because these all assets including cash is inventory, receivables cash, cash is also a current asset and these current assets is not earn any income. If they are kept in the form of the cash say cash is kept in the form of the cash, I am not talking about inventory and receivables. But when you keeping cash as a cash and large amount of the cash in the cash form in that case what is happening that this not earning anything good for us. It is only a you can call it as asset, and without any kind of incomes.

So, what should be done to maintain a liquidity, we should have two ways to keep the to maintain the liquidity, one is you keep the pure liquidity that is you keep the cash sufficient amount of the cash, so that when any current liability becomes due to be paid we have the sufficient funds for that. And if sometimes we know that we do not require the cash beyond a particular level of the beyond a particular point than that extra cash should be invested into the short-term investments.

Today we have the very short-term investment may be call deposits twenty four hours you can gives the money to use by somebody, may be weekly deposits or maybe fortnightly investments. So, these investments are called as marketable securities. So, surplus cash should be estimated regularly, and whatever the excess cash found with the form that should be invested. So, when you keep part of the cash as cash and part of the cash as marketable securities.

So, cash part is considered as the pure liquidity and the marketable securities part is considered as the mere liquidity. So, as and when you need it you can convert the marketable securities into cash and you can use it, so that way the liquidity should be maintained. And then finally but when we go to the market and say is called as a backup liquidity also pure means a near liquidity or the backup liquidity also. But that say marketable securities creation should be having two important considerations one is the return on investment how much investment we are making for how much time we are investing this money and how much return we are expecting.

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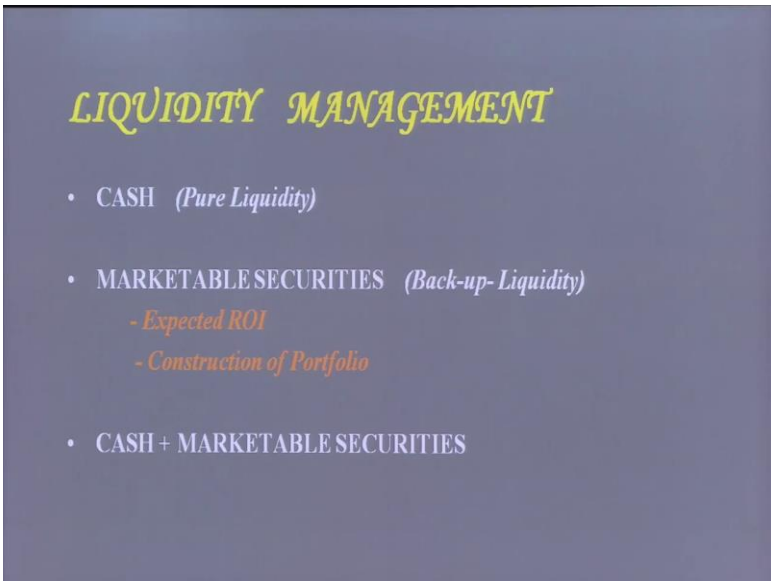

Second thing is the construction of the portfolio, a proper portfolio should be constructed, so that the total amount of the cash is not invested in the risky securities or where there is a doubt, whether it will be available on demand or not. So, proper portfolio construction is important. And then you have means you have to have the combination of both cash plus marketable securities that will be the better option. So, now we have learned about that how to manage the this cash flow statement of this process of managing the cash, and here are some other important points to be taken into account that cash management techniques are also important. If you want to improve the cash process of you want to have see collective cash with us, and we want to keep the cash properly managed.

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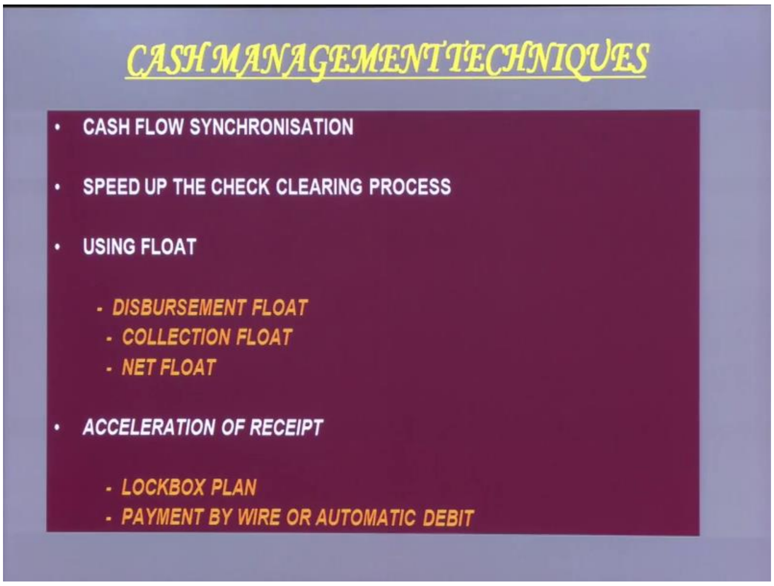

So, here are some important points they should be a borne in mind that number one is that if you want to keep a optimum amount of the cash not more not less so that the payments, you cannot also be made on time. And if there is any surplus cash that can be diverted to the marketable securities, in that case what is to be done that we have to go for the proper synchronization of the cash flows. Synchronization means we can use the budgeting process - cash budgeting process, and the budget horizons can be 1 week or 15 days.

So, if we are able to have a weekly budgeting system cash budgeting system in the beginning of the week or maybe the at the end of the previous week, you can make the budget for the next week that how much cash we miss total cash that how much cash is going to flow into the firm next week and how much cash is expected to flow out. So, that you know well in advance that whether and result is going to be surplus or deficit of cash. So, this going to be there going to be surplus you can look forward that if this much cash is going to be surplus, how I have to need the proper investment of the cash.

And if there is a shortfall of the cash then from there I have to arrange it. So, that when the time comes that when you have the surplus cash you know where it has to go. And there is a shortage then you already know that where it has to come from, so that the payments are made on due date there is no technical insolvency. So, for that reason we will have to go for the proper synchronization.

And synchronization can be facilitated with the help of the cash budgeting. And the cash budgeting is possible, if you want to bring down the time horizon from say 1 months to 15 days or 1 weeks then you have to have a better improved IT systems put in place you have to put in place the better in improved IT systems which keep on automatically preparing the cash budgets. And we can easily find out how much is cash is flowing out, how much cash is flowing in, so that there is no problem. And you can run the show even by keeping a less than optimum amount of the cash also, so that the cost can be reduced and the say return of that surplus cash investing that cash outside can be improved.

Then we can speed up the cheque clearing process. Now, these days business received the cash with the help of cheques or sometimes with the help of say online also. So, now, the firms should try that if they are say making the payments, they should make the payments through cheque, but if they have to receive the cash then the cash should be received online. Or if it is cheque system in both the cases, there cash is coming in from the with the help of cheque and going out with the help of cheque in that case the collection should be a clearing system should be very, very prompt. Means what should they do that when the cash cheque comes in you received by the firm immediately there should be sent to the bank so that it is collected as early as possible.

If you delay the cash collections, if you delay the cash clearing and the cash collections again it has a cost and ultimately artificially it receives a cash balance, there is a firm has more cash balance. But when the collection system clearing system is poor then the firm is not able to identify how much cash they already have, and they are not able to make the proper use of that that cash, so that has to be done.

And then we have to go for the say another thing, we can technically do that is we can use floats, we can use floats. So, I think you must not have heard, but is a floats system. So, float is basically of three kinds one is the disbursement float, other is the collection float, and third one is the net float. Disbursement float means when any payment the firm has to make, they should try to means they should make the payment in such a way that firm has issued the cheque to the supplier or to whom the payment has to be made, but the clearing process when the cheque is put in the bank by the receiver of that check that check is taking a longer time for clearing.

For example, it can be possible that say there is one company having there two companies buyer and supplier. So, buyer is buying the raw material from the supplier and both the companies are in Delhi, and they have means the buyer has got an arrangement made with the help of or with the agreement of supplier that you will keep mean supplying the product, and you will give me the credit period for 1 month. After 1 month, I will make you the payment through cheque and the check will be issued by our Guwahati office not by the Delhi office, because if cheque is issued by the Delhi office and receiver is also in Delhi. So, what will happen immediately the cheque will reach him, he will put into the bank and local clearing within I think three days, the money will be transferred.

But if that company who is the buyer, if he is having a economic might financial might they can say that we have opened a office in Guwahati and from Guwahati all the payments are made. So, you will receive the cheque and you will get the payment. So, you see on the due date then a say company may send the check from Guwahati and may be on the end of thirtieth day evening the Cheque reaches or maybe the next day Cheque the supplier office. Then what will happen cheque supplier will deposit that check in the bank cheque will go to Guwahati and then it will come back. So, clearing will take about 2 weeks time. So, you have means you can do more business by delaying the disbursement you are disbursing the payment also, but actually payment is not getting debited from the paying companies account, and receiver feels that we have received the payment, but is actually not received by them that could be called as the disbursement float.

And second is collection float there when any company has to receive the payment. It should be their approach that they receive it on the due date may be it is a cheque they received it from the nearest office nearest branch or nearest office, so that immediately it is received, put in the bank for collection, clearing and within 2-3 days the payment is collected by the. So, for disbursement the approach should be that you take you enjoy more time you make the payment, but their cheque clearing takes more times, you could make that kind of arrangements the receives you can have the arrangement that it is see from the nearest office of the buyer, and immediately he sends the cheque and firm is receiving the cheque, cheque goes to the back and clearing is done. And net float means the difference between the disbursement float and the collection float.

For example; disbursement float is when any company X Company makes the payment to Y Company. So, our X Company gives the check and this is the disbursement float for X Company. So, disbursement float for the X companies 4 days that after 4 days the payment is transferred to the account of Y Company, but when this company maybe and X Company is dealing with the Z also. So, X Company is making the payment to Z. So, or say X Company is dealing with the Z also then Z is a buyer from the X and Z is making the payment to the X. So, when X receives the money from Z, it is from the nearest office. So, this is called as collection float. So, this collection float is for example, it is of 2 days.

When here their payments X payments are made to buy in four days means after four days the X account is debited by the clearing process initiated by the buy. And here in this case X is receiving the payment and then the Z have to make the payment, so that is called as a collection. So, x is so from that immediately they receive the cheque they send it back in within 2 days the clearing is done. So, it means net float will be 4 minus 2 that is 2. So, firm should try to maximize the net floats and after the other than that they can have some collection process collection of the funds process can also be improved. For that they can use the lockbox plan or online transfers can be online transfers can be say accepted or they can be allowed.

So, when we talked about the lockbox plan, lockbox means there is a one box in the branch and almost nearby peers are informed that you go and put the cheque in that box and their branch is authorized by the company that you take a open the box, take out the cheques and credit those cheques in our account. So, that will facilitate speed up the collection process. So, number one that synchronization should be better than the clearing should be better, collection should be better, net floats should be improved and say the collection process of the money the funds which are due to be received should be improved.

So, this is something theoretical foundation of the cash flow statement which I am say ending here not taking you further. So, your may say important concern here is learning how to prepare the cash flow statement by say dividing the cash inflow and outflow into operating investing and financing activities and that we will be learning and we will be analyzing that cash flow statement and that is our job and that is our purpose here. So, learning how to prepare the cash flow statement, I will be talk into you in the next part of discussion.

Thank you very much.